A comparative study of sovereign investor models: **Sovereign fund profiles**

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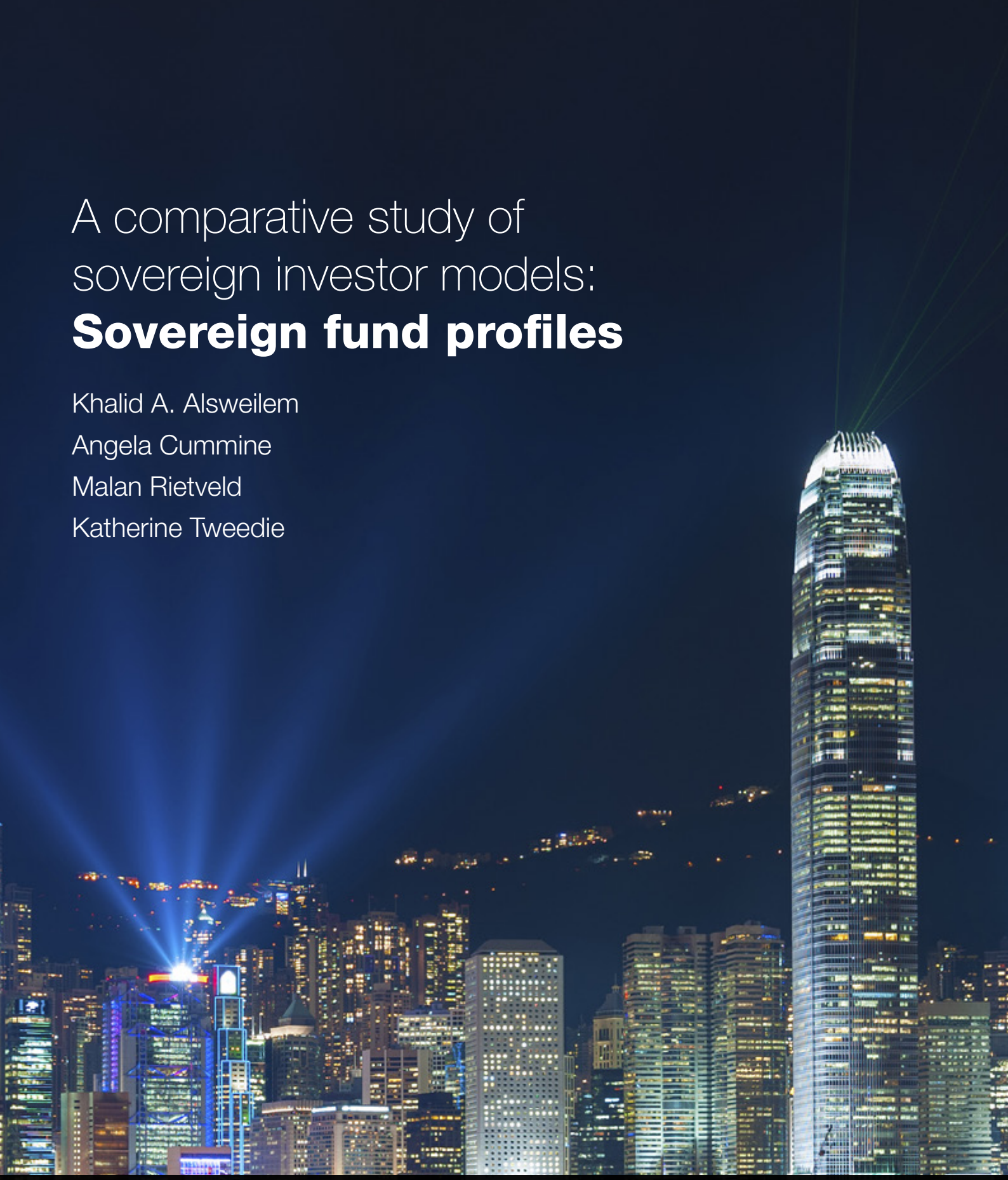

HARVARD Kennedy School
BELFER CENTER
FOR SCIENCE AND INTERNATIONAL AFFAIRS

Center for International Development
at Harvard University

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A joint report by

The Center for International Development
Harvard Kennedy School

The Belfer Center for Science and International Affairs
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Background and acknowledgements

Background

This research features the insights of experts from a number of the world's leading universities, former policymakers, and investment professionals. The report is the result of collaboration between two centers at Harvard Kennedy School: the Belfer Center for Science and International Affairs and the Center for International Development (CID).

Dr. Khalid Alsweilem, the former Chief Counselor and Director General of Investment at the Saudi Arabian Monetary Agency (SAMA), joined the Belfer Center as a Fellow in 2013 to conduct research on sovereign wealth funds, with a particular focus on the management of Saudi Arabia's reserves and their links to the real economy. He is one of the longest serving and most successful sovereign investment practitioners, having held senior investment positions at SAMA for over two decades.

Malan Rietveld and Angela Cummine are sovereign wealth fund experts and have conducted doctoral research on the topic at Columbia University and the University of Oxford, respectively. Katherine Tweedie has led the Investec Investment Institute's collaboration with CID, supporting Professor Ricardo Hausmann and his team's groundbreaking research on the role of productive knowledge as a primary driver of economic growth.

In this report, we profile a number of the world's leading sovereign funds. It accompanies another report, *Sovereign investor models: Institutions and policies for managing sovereign wealth*, which categorizes various types of sovereign investors and provides a detailed discussion of sovereign investors' macroeconomic policy frameworks and governance arrangements. This report examines sovereign investor arrangements across 12 countries and 15 funds or institutions, providing deeper insight into:

- Rule-based approaches to spending and saving commodity revenues;
- Design of sovereign fund models with income stabilization or long-term wealth management mandates;
- Governance structures, allocation of roles and responsibilities and intra-governmental reporting lines within sovereign investment entities.

The following sovereign investment institutions are profiled in depth in this report, using a consistent analytical framework:

Abu Dhabi: Abu Dhabi Investment Authority

Botswana: Pula Fund

Chile: Pension Reserve Fund and Economic and Social Stabilization Fund

China: China Investment Corporation and State Administration of Foreign Exchange

Hong Kong: HKMA Investment Portfolio

Kazakhstan: National Fund of Kazakhstan

Kuwait: Kuwait Investment Authority

Norway: Government Pension Fund Global

Saudi Arabia: Saudi Arabian Monetary Agency

Singapore: Temasek and Government Investment Corporation

South Africa: Public Investment Corporation

South Korea: Korea Investment Corporation

Acknowledgements

Since 2013, the Investec Investment Institute has provided financial support to CID as a Founding Member of the Atlas of Economic Complexity. The experience and expertise of CID scholars, notably Professor Hausmann and Eduardo Lora, on the management of resource revenues and sovereign wealth funds has been highly influential in the development of this report. The Investment Institute is the independent strategic insights platform of Investec Asset Management, a global asset manager whose clients include pension funds, sovereign wealth funds and other institutional investors from around the world.

Author biographies

Khalid Alsweilem

Former Director of Investments, Saudi Arabia Monetary Agency

Fellow, Belfer Center, Harvard Kennedy School

Dr. Khalid Alsweilem is the former Chief Counselor and Head of Investment at the Saudi Arabian Monetary Agency (SAMA). He joined SAMA in 1991 after completing a two-year post doctoral fellowship at Harvard University's Department of Economics, focusing on the application of portfolio theory to government finance in Saudi Arabia, uncertainty in export earnings, and producer-consumer cooperation in the global oil market. Dr. Alsweilem served as SAMA's Head of Investment Management (Chief Investment Officer) and from 2002, Director General of the Department in addition to his role as the CIO. He was also responsible for the implementation of SAMA's monetary policy operations to ensure banking sector system liquidity and the strength and stability of the Saudi local currency.

Dr. Alsweilem is currently a non-resident Fellow at the Belfer Center for Science and International Affairs at the Harvard Kennedy School where his research focuses the design and governance of sovereign wealth funds, with a particular focus on Saudi Arabia's reserve funds and their linkages to the real economy. Dr. Alsweilem holds a BS in Industrial Engineering from the University of Arizona, an MA in Economics from Boston University, and a PhD in Economics from the University of Colorado, Boulder.

Angela Cummine

British Academy Post-doctoral Fellow, University of Oxford

Dr. Cummine is a British Academy Postdoctoral Fellow at the University of Oxford where she completed a doctorate on Sovereign Wealth Funds (SWFs), identifying principles for their proper management, investment and distribution. Her post-doctoral research focuses on the governance of and democratic rights to state-owned financial entities. Prior to this, she worked at the Official Monetary and Financial Institutions Forum (OMFIF), as co-editor of the Global Public Investor 2014, a new worldwide publication on public sector asset management at official institutions. During her doctoral studies, she worked as a consultant to the inaugural Chairman of the Australian Future Fund and the International Forum of Sovereign Wealth Funds (IFSWF) on the fair treatment of SWFs, the OECD (Paris office) on international investment issues and Institutional Investor's Sovereign Wealth Centre as an SWF analyst. She commenced her career in the Australian Department of the Prime Minister and Cabinet as a policy advisor to the Prime Minister's office.

Angela holds a PhD and Masters (with Distinction) in Political Theory from the University of Oxford where she was a Rhodes Scholar and Jenkins Memorial Scholar. She holds a 1st Class Honours BA LLB from the University of Sydney and is an admitted lawyer in the Supreme Court of NSW (2007).

Malan Rietveld

Director, Investment Institute, Investec Asset Management

Fellow, The Center for International Development, Harvard Kennedy School

Malan Rietveld is the Director of the Investment Institute. His focus is on policies towards investment around the extractive industries, including resource-related infrastructure, foreign direct investment and the management of resource revenues. Previously, he worked in the Emerging Market Debt team at Investec Asset Management and was involved in the firm's advisory work with central banks and sovereign wealth funds. Prior to that he worked at Central Banking Publications and the Official Monetary and Financial Institutions Forum in London. He is the editor of three books on sovereign wealth funds: Sovereign Wealth Management (with Jennifer Johnson-Calari), *New Perspectives on Sovereign Asset Management and Sovereign Risk Management.*

Malan holds an M.Sc in Economics from the University of Leuven and an M.Sc in Economic History from the London School of Economics. He is currently completing his PhD in Economics from the University of Stellenbosch on the topic of sovereign wealth funds.

Malan is a Fellow at the Center for International Development at Harvard Kennedy School and a Fellow of the Columbia Center for Sustainable Investment at Columbia University.

Katherine Tweedie

Executive Director, Investment Institute, Investec Asset Management

Katherine Tweedie is the Executive Director of the Investment Institute where she plays a central role in managing the thought leadership and strategic engagement of Investec Asset Management. The primary purpose of the Investment Institute is to develop in-depth research and thought leadership that supports the firm's investment teams and the asset allocation decisions of its clients which include central banks, foundations, sovereign wealth funds and pension funds from around the world. She has extensive prior experience in investment banking and private equity and was formerly Head of Africa for the World Economic Forum, where she was responsible for key relationships and strategic initiatives with government and business leaders at Davos and the World Economic Forum on Africa. She commenced her career in mergers and acquisitions at a Canadian investment bank and subsequently joined a pan-African private equity firm based in Johannesburg.

Katherine holds a Masters in Public Administration from the Harvard Kennedy School of Government where she was selected as an Edward S. Mason Fellow and won the Raymond & Josephine Vernon and Lucius N. Littauer Awards for academic excellence and leadership. She holds a B.Com in Finance and Economics from the University of Victoria, Canada.

Analytical Framework

▶ This report is part of a research project on sovereign investors that involves scholars from a number of the world's leading universities, former policymakers and the Investment Institute of Investec Asset Management. The research is the result of a collaboration between the Investment Institute and two centres of the John F. Kennedy School of Government at Harvard University: the Belfer Center for Science and International Affairs and the Center for International Development (CID).

In this report, we profile a number of the world's leading sovereign funds. It accompanies another report, *Sovereign investor models: Institutions and policies for managing sovereign wealth*, which categorizes various types of sovereign investors and provides a detailed discussion of sovereign investors' macroeconomic policy frameworks and governance arrangements. This report examines sovereign investor arrangements across 12 countries and 15 funds or institutions, providing deeper insight into:

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The following sovereign investment institutions are profiled in depth in this report, using a consistent analytical framework (see following page for details on the framework used):

01. **Abu Dhabi**: Abu Dhabi Investment Authority
02. **Botswana**: Pula Fund
03. **Chile**: Pension Reserve Fund and Economic and Social Stabilisation Fund
04. **China**: China Investment Corporation and State Administration of Foreign Exchange
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08. **Norway:** Government Pension Fund Global
09. **Saudi Arabia**: Saudi Arabian Monetary Agency
10. **Singapore**: Temasek and Government Investment Corporation
11. **South Africa**: Public Investment Corporation
12. **South Korea**: Korea Investment Corporation

All currencies/figures are in US dollars unless otherwise stated.

Sovereign Fund Profiles

The research team used a consistent framework to analyse the funds and sovereign investment institutions profiled in this report. The profiles of the case study funds are current as at October 2014, unless stated otherwise.

▶ I. Economic and political context:

– We start with a snapshot of each fund/institution summarizing key features, such as its year of establishment, assets under management and investment model.

– We then discuss the history, evolution, major events and changes around the fund/institution.

– Finally, we explain the fund's role in relation to the economic context (i.e. reducing resource dependence, saving revenues for future generations, generating investment returns for fiscal spending);

II. Official mandate(s):

– How are the fund/institution's mandate defined?
  – Stabilisation, income generation, developmental and savings;
  – Hybrid/combined mandates.

– If applicable, we distinguish further between the fund/instituition's:
  – Broad institutional mandate (example: 'safeguard assets for future generations');
  – Specific investment mandate (example: 'diversified portfolio with long horizon');
  – Target return, where disclosed (example: '4%average real return');
  – Risk parameters, where included in investment mandate (example: 'maximise investment returns without incurring undue risk to the fund as a whole').

III. Source of funding:

– At highest level, we can distinguish between commodity-revenue and foreign-reserves based funds.

– Then, we distinguish within those categories more closely, for example:
  – Taxes on private mining/oil companies;
  – Profits of state oil/mining;
  – Fiscal surplus or formula-derived transfer;
  – Exchange-rate intervention based reserve accumulation.

– Ultimately, we try to determine the fund/institution's savings rule/practices, through which transfers to fund are achieved.

IV. Liabilities:

– We distinguish between 'pools of assets' (no liabilities), and fund/institutions with implicit and explicit liabilities.

– Are liabilities and outflows rule-based or discretionary?

– Ultimately, we try to determine the fund/institution's spending rule/practices, through which transfers from fund are achieved.

V. Governance structure:

– We focus on five dimensions of 'governance':
  – **Fund flows** (saving/spending rules): what processes and legal procedures govern these rules and potentials changes to them?
  – **Public sector placement:** is the fund located in the central bank, a government ministry or dedicated institution – or some clear combination of these?
  – **Institutional (or internal) governance:** the powers of the Board versus Executive; the degree of political vs. technocratic representation; appointment processes; reporting lines;
  – **Investment process:** who determines strategy (risk, permitted assets, horizon); who does strategic asset allocation; who can change investment strategy (eg. permission to enter new asset classes);
  – **Transparency and disclosure:** how much is public and through which mechanisms?

VI. Investment style:

– Does the fund/institution manage a long-term, diversified portfolio; does it hold illiquid and private-market positions; is the portfolio more liquidity-orientated?

– Degree of active versus passive investment: does the fund try to outperform markets; or simply capture market returns?

– Degree of Internal vs outsourced mandates/managers.

Contents

Abu Dhabi:
Abu Dhabi Investment Authority

▶ Key features

– The Abu Dhabi Investment Authority (ADIA) is one of the largest SWFs in the world, and one of several state-owned investment vehicles owned by the government of the Abu Dhabi Emirate (including the Mubadala Development Company, the Abu Dhabi Investment Council and the Abu Dhabi Investment Company);

– The exact size of ADIA's assets under management is not disclosed – consequently, estimates are in a wide range from $400 billion-$900 billion. A value in excess of $750 billion is most realistic;

– While ADIA does not disclose details of its portfolio and specific holdings, recent disclosures have confirmed that the fund has a highly diversified global portfolio of public, private and alternative assets, with considerable geographic dispersion;

– ADIA's highest level governing body is a nine-member Board of Directors, appointed by the Emir of Abu Dhabi, with over half of its members coming from Abu Dhabi's ruling family. The Emir also serves as the Chairman of the Board;

– The Managing Director serves as chief executive of ADIA and is responsible for investment and operational decisions, reporting to the Board of Directors, of which the Managing Director is also a member. An Investment Committee advises the Managing Director on investment policy and external manager selection and performance (around 75% of ADIA's assets are managed externally).

Fund snapshot

Year Established	1976	
Assets Under Management	Unconfirmed, but estimated at $770 billion	
Source of Funds	Oil-related fiscal revenues	
Portfolio at a glance (March 2014)	Developed market equities	32-42%
	Emerging market equities	10-20%
	Small-cap equities	1-5%
	Sovereign bonds	10-20%
	Credit	5-10%
	Alternative assets	5-10%
	Real estate	5-10%
	Private equity	2-8%
	Infrastructure	1-5%
	Cash	1-10%

I. Background: Economic and political context

The Abu Dhabi Investment Authority (ADIA) is the manager of largest and most established of the Emirate's numerous SWFs. Abu Dhabi, with a population of 420,000, has around 10% of the world's proven oil reserves (and 5% of gas reserves). Oil and gas completely dominates economic activity, fiscal revenue and export earnings.

The origins of ADIA can be traced to the 1960s, when officers of the British colonial administration ran an investment Board to manage the revenues from oil, a resource which had been discovered in the 1930s. The Financial Investments Board and the Abu Dhabi Investment Administration were created in 1967 and 1971 respectively. The Abu Dhabi Investment Authority was first established through the passage of a law in 1976. In addition to the headquarters in Abu Dhabi, ADIA maintains an office in London.

For many years, ADIA's investment strategy was highly conservative, investing almost exclusively in sovereign debt instruments of the world's leading reserve currencies. By the 1990s, however, the strategy turned more aggressive; and in recent years, it has become increasingly important to understand ADIA's role and strategy within the context of its position in the portfolio of sovereign funds owned by the government of Abu Dhabi. ADIA operates as a typical inter-generational savings fund, with a diversified portfolio of international assets and an exclusive focus on generating long-term financial returns. The fund does not invest in the economies of Abu Dhabi, the United Arab Emirates or the Gulf region, and has no purely developmental objectives, in contrast to a number of Abu Dhabi's other, and more recently established, sovereign funds. The most significant supplementary sovereign funds in Abu Dhabi include:

01. Abu Dhabi Investment Council (ADIC): the council was spun out from ADIA in 2007 and manages domestic and regional investments, and a small number of strategic foreign assets, previously under management of ADIA. Although not confirmed by the government of Abu Dhabi, it is has been reported the council receives around 30% of annual oil and gas revenues, with ADIA receiving the other 70%. Some of the most important assets and holdings of the Abu Dhabi Investment Council include:
    - Domestic banks (National Bank of Abu Dhabi, Abu Dhabi Commercial Bank, Union National Bank and Al Hilal Bank);
    - Abu Dhabi National Insurance Company;
    - Abu Dhabi Aviation Company;
    - Abu Dhabi National Chemicals Company;
    - Abu Dhabi Investment Company (see below).

02. Abu Dhabi Investment Company (also known as Invest AD): Invest AD is owned by the government of Abu Dhabi, through the Abu Dhabi Investment Council. Its specialisation is in frontier and emerging markets, particularly in Africa and the Middle East. Invest AD is set up as an in-house asset management boutique, and manages equities and fixed income funds, discretionary managed accounts, and the sub-advisory services to other asset managers and financial institutions;

03. Mubadala Development Company: established in 2002, Mubadala is a domestically orientated development sovereign fund. Mubadala's mandate is to invest part of Abu Dhabi's wealth in strategic sectors, industries and companies that assist in diversifying the Emirate's economy away from energy dependence. Although Mubadala's investments are supposed to be assessed on a commercial basis and generate financial returns, there is also a clear emphasis on the strategic and developmental nature of its investment strategy. Mubadala has implemented this mandate through investments in the energy value chain (chemicals, aluminium and petroleum coke); and in new industries (notably, automotive parts, aircraft structures, semiconductors and financial services) and more public-benefit type areas (healthcare, infrastructure and utilities).

Since 2007, the role of ADIA as an international portfolio investor with a long-term saving and investment-income generating mandate, has come into sharper focus – while a set of more domestically-orientated sovereign funds have been empowered to pursue developmental and diversification purposes through the investment of oil and gas revenues

II. Official mandate(s)

The Abu Dhabi Investment Authority is a classic example of a savings fund, with the objective and institutional mandate of preserving some part of the revenues from a depleting resource (in this case, oil) for future generations and spending needs. The institution's stated mission is to invest funds on behalf of the Abu Dhabi government 'to secure and maintain the future welfare of the Emirate'.

In terms of ADIA's investment mandate, the organisation itself refers to its 'economic objectives' in fairly general terms: 'delivering sustained long-term financial returns'. It does not seek an active role in the management of the companies in which it invests and its investment decisions are based solely on its economic objectives. Neither does it disclose its target return or detailed strategic asset allocation (although general indications of its asset-class exposure are made)

III. Source of funding

Under the constitution of the United Arab Emirates, natural resources and wealth are the public property of the Emirate in which they are located. Consequently, ADIA 'receives funds of the Government of the Emirate of Abu Dhabi that are allocated for investment, and invests and reinvests those funds in the public interest of the Emirate'. Importantly, ADIA's assets are essentially a fiscal transfer and it is clear that they are not classified as part of either the UAE or Abu Dhabi's foreign exchange reserves.

The process for allocating and transferring revenues to ADIA is not rule based (or, at least, any possible rule-based allocation is not disclosed). However, ADIA's assets are based on three sources:

01. Budget surpluses, which arise from an excess of petroleum revenues, from the Government of the Emirate of Abu Dhabi are transferred to ADIA. A precise definition for what constitutes 'petroleum revenues' is not provided, but, in practice, includes taxes on oil companies, as well as profits from the Abu Dhabi National Oil Company;

02. Investment income from returns made by ADIA is reinvested by the fund;

03. The Abu Dhabi National Oil Company (ADNOC) pays an undisclosed percentage of its income directly into two natural resource funds (Abu Dhabi Investment Council and the Abu Dhabi Investment Authority). The fourteen subsidiaries of ADNOC account for approximately 80% of Abu Dhabi's national income (ADIA reportedly receives around 70% of ADNOC income, while the Abu Dhabi Investment Council receives the remaining 30%).

Neither the Abu Dhabi government nor ADIA have, historically, disclosed the extent or profile of transfers of revenues to the Authority (or Abu Dhabi's other sovereign funds). The size of the funds under the management of ADIA has been the subject of much speculation, and has been conservatively estimated at around $400 billion, although is most commonly believed to be between $700 billion and $800 billion.

IV. Liabilities

Like the source of funds (or the 'savings rule'), the liabilities (or 'spending rule') of ADIA are not clearly articulated or underpinned by a publicly disclosed rule or formula. By law, ADIA is required to make funds available for withdrawal by the government whenever needed; however, such withdrawals occur infrequently and are limited to prolonged periods of historically low petroleum prices and consequent fiscal revenue shortfalls.

There is a clear separation between ADIA, which invests in financial assets outside the region for long-term financial returns; and the general public investment and spending of the government through the fiscal process and it's domestically and regionally focused sovereign funds.

V. Governance structure

Great strides have been made by ADIA around the disclosure of its mandate, objectives and strategies; however, it remains one of the least transparent sovereign funds in the world. While ADIA has been willing to make gradual disclosures about the broad contours of its portfolio – and its institutional and investment objectives and mandate – details of its holdings, asset allocation, and target and realised returns are still not public information.

External governance

i. Savings and spending rules

The governance of the allocation and transfer of funds between ADIA, Abu Dhabi's other sovereign funds, and the general budget is a particularly obscure element of the Emirate's management and investment of resource revenues. The government has not disclosed rules or procedures for such distributions, and particularly the decisions around the allocation of assets between Abu Dhabi's various sovereign funds.

ii. Placement and reporting lines within the public sector

ADIA was established as an independent government investment institution in 1976, with minor changes to the law governing the institution, being made in 1981. It is wholly owned by — and subject to supervision by — the Abu Dhabi government. Additionally, it carries out its investment programme independently and without reference to the Abu Dhabi government or the other institutions that also invest funds on behalf of the government.

There is a legal separation of roles and responsibilities among the owner, the governing entity and the management (see also the section on institutional governance). The role and responsibilities of the most important public stakeholders involved with ADIA are as follows (see Figure 1 opposite):

01. The **Government of Abu Dhabi**, under the former Emir of Abu Dhabi, passed the legislation creating ADIA; and is the legal owner of ADIA and its assets;

02. The **Board of Directors** provides oversight of ADIA's management. The Board's nine members are appointed by the Emir of Abu Dhabi for three-year periods which are renewable, with over half of its members coming from Abu Dhabi's ruling family. The Emir also serves as the Chairman of the Board;

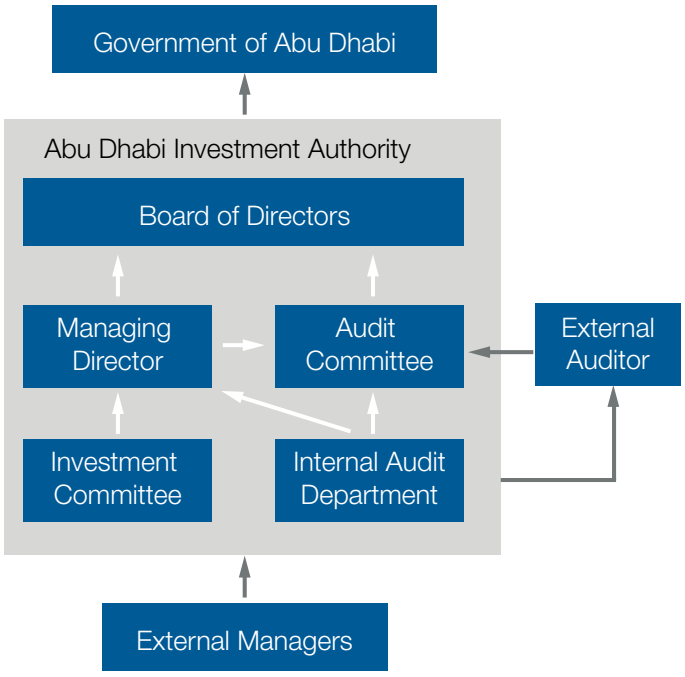
03. The **Managing Director** of ADIA is responsible for investment and operational decisions and reports to the Board of Directors, of which the Managing Director is also a member;

04. The **Investment Committee** advises the managing Director on investment policy and external manager selection and performance (around 75% of ADIA's assets are managed externally);

05. An **Internal Audit Department** reports to the Managing Director and the Board of Director's Audit Committee;

06. The **Audit Committee** oversees and appoints two external auditors.

Figure 1: The inter-institutional reporting structure for ADIA



Source: ADIA

iii. Transparency and disclosure

Since 2008, ADIA has disclosed much more information about its broad mandate, objectives and investment strategy. Notable recent disclosures include the publication of an annual report (without detailed financial statements or portfolio details), a dedicated ADIA website, a clarification of its external and internal governance framework, broad asset-class allocation ranges, and selected benchmarks. In recent years, it has also participated in the formulation of the Santiago Principles and participated in the regular meetings of the International Forum of Sovereign Wealth Funds.

However, there are areas which remain obscure, including: the savings rule pertaining to the fund, the size of its assets under management, its target and actual asset allocation, specific holdings and investment performance.

Internal governance

iv. Institutional governance

As noted above, the law establishing ADIA creates a separation of roles and responsibilities among the owner (the Abu Dhabi government), the governing body and the management – the latter two bodies are involved with the institutional governance of ADIA.

Governing body

The Board of Directors is the governing body of ADIA, having absolute control over its affairs and the discharge of its business. The Board is composed of a Chairman, Managing Director and other Board members, all of whom are senior government officials appointed by a decree of the ruler of the Emirate. The Board of Directors serves mainly in an overview capacity and does not normally involve itself in ADIA's investment and operational decisions (which, by law, is the responsibility of the Managing Director and Investment Committee).

Management

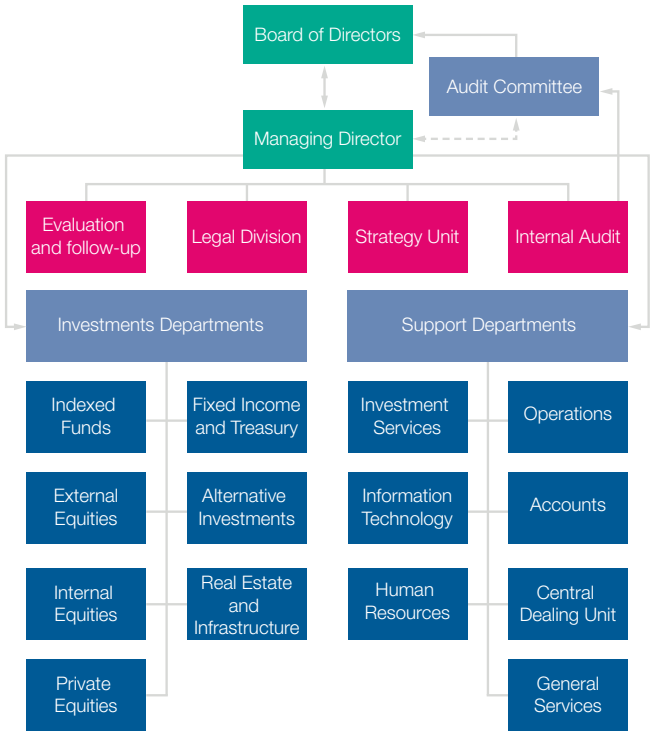
Under law, the Managing Director serves as Chief Executive, responsible for the implementation strategic policy, management and legal representation of ADIA in its relationship with third parties. The Managing Director is empowered to formulate and implement investment proposals, as approved by the Board of Directors, in relation to the objectives laid out in law. The Managing Director and his team, therefore, enjoy operational independence from the general government. The Managing Director is assisted by:

01. An Investment Committee, which is composed mainly of the heads of the several investment departments;

02. A Management Committee, responsible for overseeing non-investment related issues.

As shown in Figure 2 below, several additional divisions and departments report to the Managing Director.

Figure 2: Internal management structure of ADIA



Source: ADIA

v. Investment and risk management process

The Investment Committee assists the Managing Director with investment decisions. It comprises the Managing Director as its Chairman, and senior executives, who have a broad mix of investment and operational experience, drawn from across the organisation. A number of advisory Committees and departments support the investment and risk-management process, notably:

– The Strategy Committee advises on ADIA's overall investment strategy;

– The Investment Guidelines Committee formulates and advises on investment guidelines for individual investment departments in accordance with ADIA's investment strategy;

– The Risk Management Committee is responsible for implementing ADIA's risk management framework and ensuring that all identified risks are acted upon in a timely manner. It is comprised of members of the Investment Committee and reports to the Managing Director.

VI. Investment style

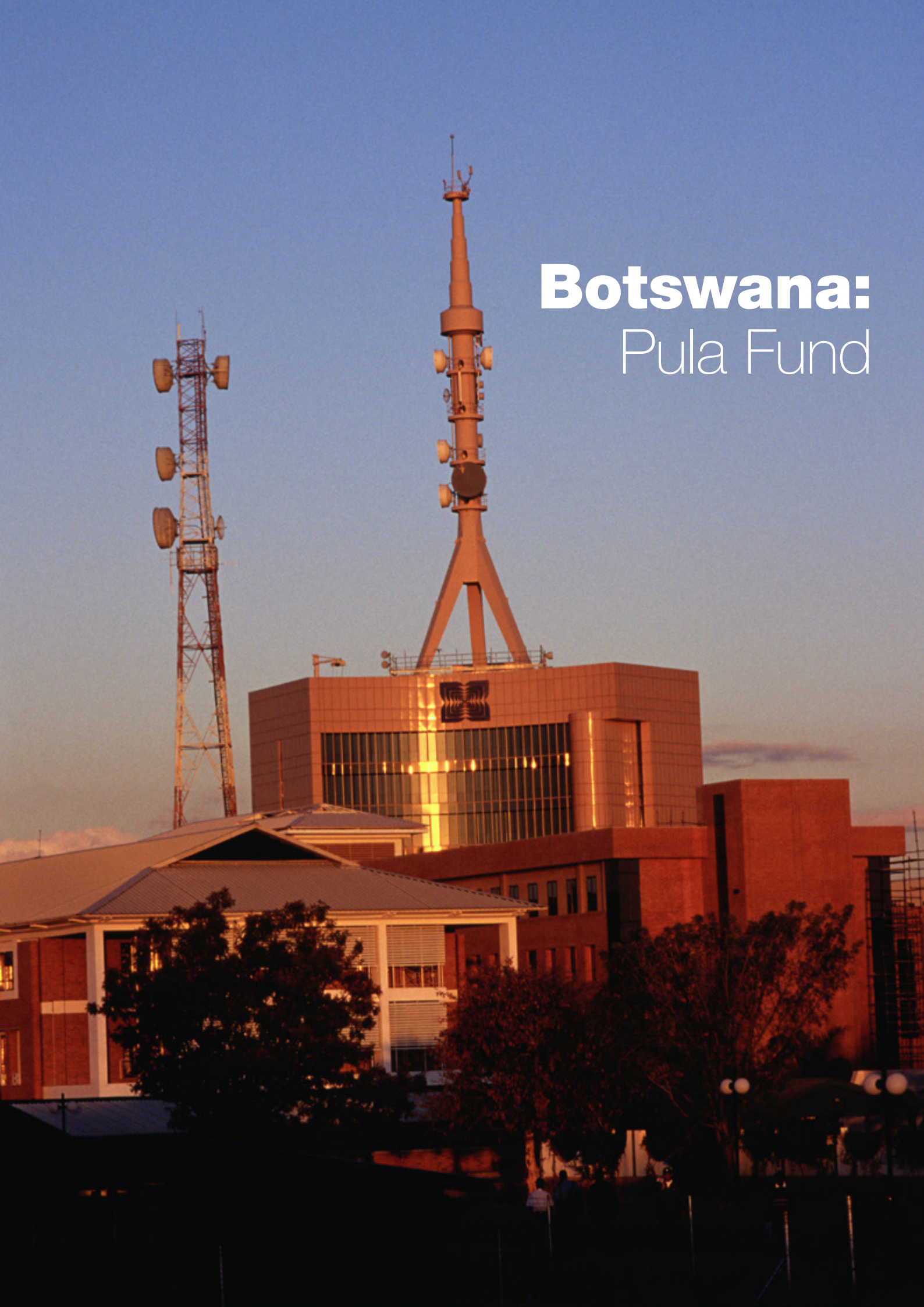
As noted above, ADIA is a diversified, global portfolio investor – it invests in both public and private assets, across asset-class, risk and geographic profiles. With assets under management presumed to be in excess of $700 billion, ADIA is one of the largest institutional investors in the world. Given its purpose and mandate, ADIA invests outside the domestic economy and even the wider Gulf region (except to the extent that such investments constitute part of an index).

In recent years, ADIA has made limited first-time disclosures around some of the broad dimensions of its portfolio's geographic and asset-class breakdown; and performance benchmarks (see Table 1 below). It also stated that its rolling 20-year rate of return is 6.4%.

Table 1: Portfolio dimensions of ADIA

GEOGRAPHIC BREAKDOWN	INVESTMENT BENCHMARK	ASSET ALLOCATION	
North America: 35%-50%	Listed Equities: S&P, MSCI and Russell Indices	Developed market equities	32%-42%
Europe: 20%-35%	Fixed Income: JP Morgan Government Bond and Barclays Inflation Linked	Emerging market equities	10%-20%
Developed Asia: 10%-20%	Alternative Investments: BTOP 50, MSCI World plus premia and regional real estate benchmarks	Small-cap equities	1%-5%
Emerging markets: 15%-25%		Sovereign bonds	10%-20%
		Credit	5%-10%
		Alternative assets	5%-10%
		Real estate	5%-10%
		Private equity	2%-8%
		Infrastructure	1%-5%
		Cash	1%-10%

Source: ADIA



Botswana:
Pula Fund

▶ Key features

- The Pula Fund manages excess foreign exchange reserves (owned by the central bank) and excess fiscal revenues (owned by the government), both arising from the country's diamond exports;
- The combination of government-owned fiscal assets and the central bank's foreign exchange reserves in the Pula Fund is unique, resulting in co-ownership of the fund and a hybrid governance model;
- The Pula Fund has a two-fold mandate that requires it to perform savings, stabilisation and investment management functions: (i) to create a financial portfolio that preserves a portion of public revenues from a depleting resource base for future generations and diversifies the government's revenue base; and (ii) to manage part of the central bank's excess foreign exchange reserves over a more long-term investment horizon, targeting higher returns, while still protecting the purchasing power of assets;
- The Bank of Botswana, the country's central bank, is responsible for both the investment policies (strategy) and guidelines (implementation) of the Pula Fund;
- The Pula Fund has a ten year investment horizon, invests exclusively in foreign assets, and has a 60% allocation to advanced-economy sovereign bonds and a 40% allocation to advanced-economy equities;
- The Pula Fund forms part of a prudent and conservative fiscal and monetary policy framework – however, many of the critical policies and governance arrangements around the fund are not established in law or other formal policies, but rather rely on the continued prudence of Botswana's leaders and policy makers.

Fund snapshot

Year Established	1993
Assets Under Management	$7 billion
Source of Funds	Excess foreign exchange reserves arising from diamond exports
Portfolio at a glance	Sovereign bonds 60% Currency allocation based on IMF's Special Drawing Rights: US dollar (49.1%), euro (37.4%), sterling (11.3%) and yen (9.4%). Equities 40% Country allocation based on MSCI developed country index weighting.

I. Background: Economic and political context

Botswana is a small, landlocked country, with a narrow economic base and a high degree of dependence on the diamond industry for both fiscal revenue and foreign exchange earnings to cover imports. Given the country's macroeconomic exposure to the volatility of global diamond demand and domestic production, Botswana's economic policy makers have long pursued a highly prudent and conservative approach to accumulating foreign assets and promoting domestic savings. In addition to a well-funded domestic public-employee pension system (the government is by far the largest employer in Botswana), the Bank of Botswana holds and manages substantial (given the size of the economy and population) foreign exchange reserves – on average equal to around 18 to 20 months of import cover.

Since 1993, a portion of these foreign exchange reserves has been managed through the Pula Fund. The Pula Fund was established in November 1993, and was subsequently re-established in the current form under the new Bank of Botswana Act in 1996. Placing excess foreign exchange reserves in the Pula Fund allows the central bank to manage these assets over a longer investment horizon than the conventional reserves portfolio, with greater adoption of risk in order to generate a higher long-run average return.

In addition to excess foreign exchange reserves (owned by the Bank of Botswana), the Pula Fund manages assets belonging to the government of Botswana in the form of excess fiscal revenues arising from earnings from Debswana (the government's diamond mining joint-venture with De Beers) and taxes and royalties on other diamond mining activities. The Pula Fund performs a number of inter-related functions, including macroeconomic stabilisation, savings for future generations and the diversification of government revenue sources.

The Pula Fund has been a robust institution and an important element of the government of Botswana's prudent and conservative macroeconomic policy framework. However, the fund's policies and governance remains somewhat dependent on the goodwill of benevolent governments and policy makers – elements of the Pula Fund's governance, transparency and accountability framework could be clarified through clear policies or established in law.

II. Official mandate(s)

Given its management of both government and central bank surplus assets, the institutional mandate of the Pula Fund is two-fold: (i) to create a financial portfolio that preserves a portion of public revenues from a depleting resource base for future generations and diversifies the government's revenue base; and (ii) to manage part of the central bank's excess foreign exchange reserves over a more long-term investment horizon, targeting higher returns, while still protecting the purchasing power of assets. In fulfilling this mandate, it is worth elaborating on the subtle differences between the various functions performed by the Pula Fund, including the following:

- Stabilisation: the Pula Fund forms part of Botswana's policy of accumulation foreign assets to provide macroeconomic, balance of payments and fiscal stability in the event of external shocks or anticipated domestic disruptions, such as diamond revenue shortfalls or droughts;
- Savings for future generations: given that the Pula Fund has grown since inception, and is expected to carry on growing, as Botswana continues to generate excess foreign exchange reserves and diamond-related fiscal revenues, the principal of the fund represents a saving for future generations that can be earmarked or used to meet future public liabilities;
- Income and foreign exchange generation: like a number of other countries with sovereign funds, Botswana follows the principle that the real (above inflation) returns of the Pula Fund can be spent through the annual budget. In addition to generating revenues for spending through the budget, the Pula Fund is also an additional source (in addition to Debswana's diamond exports) of foreign exchange earnings in aid of balance-of-payments stability;
- Income diversification: investment income generated by the Pula Fund has become the second largest source of fiscal revenue, after mining revenue (net income from Debswana, and taxes and royalties on mining activities) for the government of Botswana;
- Preventing the misuse of public assets and revenues: the government of Botswana and the Bank of Botswana have stated that long-term offshore investments are necessary to deflect demands for immediate use of revenues for unproductive or unsustainable projects.

The Pula Fund is described as a long-term investment portfolio, whose investment objectives are based on the maintenance of the purchasing power of the reserves and maximising returns within acceptable risk parameters.

III. Source of funding

The Pula Fund manages both government (or fiscal) revenues and central bank (or foreign exchange reserve) assets. In recent years, government assets have accounted for around two-thirds of the Pula Fund's assets, with the Bank of Botswana's foreign exchange reserves accounting for the remaining one-third. The Bank of Botswana holds around two-thirds of its foreign exchange reserves in the Pula Fund, with the remaining one-third held in the more short-term Liquidity Portfolio. In both cases, the source of funding arises from surpluses:

– In the case of foreign exchange reserves, the Bank of Botswana transfers assets to the Pula Fund that are in excess of what is required for intervention purposes, held in the central bank's Liquidity Portfolio. The central bank currently maintains around six months of import cover in the Liquidity Portfolio;

– In the case of fiscal revenues, funds are transferred to the Pula Fund when revenues exceed those required for investment, which rules out recurrent spending, except on health and education.

With respect to the latter, the government of Botswana follows a fiscal rule, which is not established in law, but is rather a self-enforced fiscal framework: the 'budget sustainability ratio', or 'sustainable budget index', maintains recurrent non-health and non-education spending equal to or less than non-mineral revenue. As such, mineral revenue is supposed to finance investment expenditure. Any excess fiscal revenues are not spent (except for recurrent expenditures on health and education), but rather transferred to the Pula Fund. Public investment and recurrent health and education expenditures are themselves subject to parliamentary approval in the form of rolling five-year public investment plans. The total amount of spending is further constrained by a cap that limits public spending to a maximum of 40% of GDP per year.

IV. Liabilities

The liabilities of the Pula Fund are not explicitly defined. The government and the Bank of Botswana have frequently discussed the need for accumulating foreign assets in the form of the Pula Fund to help preserve a portion of revenues and earnings from the country's depleting diamond wealth for future generations. However, the Pula Fund's assets have not been linked and matched to specific future spending needs or liabilities.

The Bank of Botswana transfers a dividend to the Ministry of Finance from the government's portion of the Pula Fund. This dividend is calculated on the basis of the expected returns over a five- to seven-year period, and is paid to the government every quarter during the fiscal year, and recorded as government revenue. There are no legal constraints on the government's ability to withdraw the assets it owns in the Pula Fund – for example, the government withdrew a significant amount of assets from the Pula Fund to establish the Botswana Public Officers Pension Fund in 2002.

V. Governance structure

The Pula Fund has a unique governance structure, given its management of both fiscal and central bank assets. With respect to its management of the former, the Pula Fund is a prime example of delegated authority, as the government of Botswana has assigned all the critical powers over the investment process to the central bank. With respect to the assets of the Pula Fund owned by the central bank, the governance model is much more conventional, as the Pula Fund is simply a vehicle through which the central bank adopts a more long-term, return-orientated approach to investing the foreign exchange reserves it owns. The Pula Fund is a well-run, highly prudent institution; however, some additional steps to improve transparency and clarify the rules governing the transfer of funds and assets between the government, the central bank and the Pula Fund may be needed for the fund to keep pace with evolving best practices of global sovereign funds.

External governance

i. Savings and spending rules

The transfer of fiscal surpluses to the Pula Fund is governed by the government of Botswana's commitment to prudent fiscal policy, specifically the Sustainable Budget Index (described above). This framework is not established in law, but is rather an outcome of government's belief that recurrent expenditures should not be dependent on volatile and finite diamond revenues. The spending of investment income on the government-owned assets in the Pula Fund is governed by the revised Bank of Botswana Act of 1996, which states it should be based on expected real returns on a five to seven year basis.

The transfer of excess foreign exchange reserves from the Bank of Botswana's Liquidity Portfolio to the Pula Fund is, similarly, governed by the central bank's self-established framework of limiting the amount of reserves in the Liquidity Portfolio to around six months of import cover.

The self-enforced saving and spending mechanisms underlying the two components of the Pula Fund have served Botswana and the fund well since inception, given the prudence of the country's leaders and policy makers, and the steady flow of fiscal surpluses and excess foreign exchange earnings linked to diamond production and exports. However, many SWFs – particularly the more transparent and accountable ones – have taken steps, in recent years, to clarify and solidify such savings and spending rules and mechanisms in law (or decrees and Memorandum of Understandings).

ii. Placement and reporting lines within the public sector

The government and the Bank of Botswana jointly own the Pula Fund, given their respective ownership of the fund's underlying assets. The government's share of the Pula Fund (currently around two-thirds) is clearly accounted for on the balance sheet and income statements of the Bank of Botswana.

The Bank of Botswana is solely responsible for the investment strategy and management of the Pula Fund, through its financial markets departments, which report to the governor of the central bank. The central bank regularly consults the Ministry of Finance on strategic asset allocation, which is determined through an efficient portfolio optimisation model. The Bank of Botswana manages around 50% of all assets under its management (i.e., the Pula Fund and the Liquidity Portfolio) in-house. The central bank's investment teams manage, in particular, fixed-income portfolios, while external managers are mandated to manage around 50% of all assets, particularly equity portfolios.

iii. Transparency and disclosure

The financial and investment activities of the Pula Fund are reported in the financial statements of the Bank of Botswana. Annual financial statements are audited by external auditors and submitted to the minister of finance and development planning, for submission to parliament. The Pula Fund and the Bank of Botswana are active participants in the international community of SWFs, including the International Forum for Sovereign Wealth Funds. However, the Pula Fund lags behind a number of leading SWFs, in terms of disclosure and communication of the details of its portfolios and the exactly articulation of its mandate, objectives and goals.

Internal governance

iv. Institutional governance

The central bank's Board decides on policy and delegates implementation responsibility to the governor of the Bank of Botswana and the central bank's financial markets department. The Board consists of up to nine members, including the Fovernor (ex officio), the permanent secretary of the Ministry of Finance and development planning (ex officio), and seven other members in their individual capacity, appointed by the Minister of Finance and development planning.

Appointed Board members are drawn from across government (up to a maximum of two), academia and the private sector based on their good standing and experience. Their appointment, which can be renewed, is for a period of up to four years. The Board is required to meet at least once every quarter, and more often if required. The governor of the Bank of Botswana chairs the Board. Two sub-Committees, the audit and remuneration Committees, chaired by non-executive Board members, support the work of the Board. Logistical support for the work of the Board is provided by the Board secretariat, part of the management services department.

The day-to-day management of the Pula Fund is conducted by the Bank of Botswana's financial markets department, which manages the central bank foreign exchange reserves (as well as domestic market operations). The financial markets department is responsible for establishing and implementing the central bank's reserves management guidelines, managing in-house portfolios and for overseeing the performance of external managers.

v. Investment and risk management process

The governance structure around the investment process of the Pula Fund places all the significant power in the hands of the Bank of Botswana, which determines the investment policies and strategies, and oversees their implementation. The former is consolidated in the Investment Policies document for the management of all the central bank's foreign exchange reserves. The Board of the Bank of Botswana establishes the investment policies, which include the strategic asset allocation, determined with the assistance of an efficient portfolio optimisation exercise. The Bank of Botswana reviews the Pula Fund's investment policies every three to four years.

The strategies for implementing these policies are contained in the investment guidelines, established by the Financial Markets Department. The investment guidelines includes details around minimum credit ratings for fixed income assets, the monitoring and management of currency, credit and interest-rate risk, and the performance benchmarks used for evaluating fixed income and equity mandates.

VI. Investment style

Investments of the Pula Fund comprise long-term assets, such as long-dated bonds and equities actively traded in liquid markets, with the expectation of earning a higher return than could be achieved on conventionally managed investments. The asset allocation between bonds and equities is determined using a combination of historical data and assumptions in an efficient portfolio optimisation framework. Exercises are also conducted in respect of the Pula Fund risk/return sensitivity analysis, using different portfolio options, where risk is measured by a standard deviation on the rate of return. The Pula Fund's investment horizon is stated as 10 years.

As of early 2014, the Pula Fund consisted of a 60% allocation to advanced-economy sovereign bonds and a 40% allocation to advanced-economy equities. The currency allocation of the bond portfolio is based on the formula used for the IMF's Special Drawing Rights: 49.1% US dollar, 37.4% euro, 11.3% sterling and 9.4% yen. Eligible debt instruments must carry a minimum rating of Aa2/AA by Moody's and S&Ps (Baa3/BBB- in the case of G7 member countries). The country allocation of the equity portfolio is based on MSCI Index weighting.

Chile:
Pension Reserve Fund and Economic and Social Stabilisation Fund

▶ Key features

– Chile has two sovereign funds for the management of its copper revenues: a long-term saving fund, aimed at meeting future pension and social welfare liabilities; and a stabilisation fund, aimed at reducing the volatility of the annual fiscal process.

– Chile's funds rank among the most transparent in the world, and have a clear and simple governance structure, involving the:
  – Ministry of Finance, who owns the funds and determines their investment and operational policies;
  – Central Bank of Chile (CBC) as operational investment manager of both funds (including the allocation and oversight of external investment mandates in equities and corporate bonds), implementing a largely passive, index-driven investment policy.

– The CBC has little discretion over investment, given the passive, benchmark-driven investment model;

– A Financial Committee, consisting of five members with extensive experience in the areas of finance and economics in academia, the private sector and the civil service, guides the Ministry of Finance on fundamental aspects of investment policy.

Fund snapshot

Year Established	2006	
Assets Under Management (as at Jan 2014)	$7.4 billion (PRF) and $15.6 billion (ESSF)	
Source of Funds	Copper-related fiscal revenues	
Portfolio at a glance (PRF)	Nominal sovereign bonds	48%
	Inflation-indexed sovereign bonds	17%
	Stocks	15%
	Corporate bonds	20%
Portfolio at a glance (ESSF)	Money market instruments	30%
	Nominal sovereign bonds	66.5%
	Inflation-indexed bonds	3.5%

I. Background: Economic and political context

Chile established two sovereign funds in 2006 by an Act of Parliament, the Fiscal Responsibility Law 2006. The Pension Reserve Fund (PRF) helps to finance pension and social welfare spending, while the Economic and Social Stabilisation Fund (ESSF) helps overcome fiscal deficits when copper revenues decline unexpectedly. These classic savings and stabilisation funds form part of a rule-based fiscal framework, which clearly articulate the framework for transferring revenues between the budget and the two funds.

The funds were preceded by the Copper Compensation Fund, a fiscal stabilisation fund, established in 1985; and by the implementation of a structural balance rule to smooth fiscal spending and deposit surpluses in the fund. The 2006 law and the two funds it established, therefore, simply improved and clarified the existing fiscal rules framework and stabilisation fund, while adding a long-term saving fund in the form of the PRF.

Both funds are under the management of the Ministry of Finance, with the CBC providing operational management of a largely passive, index-driven investment policy. Since January 2007, the financial Committee, consisting of five members with extensive experience in the areas of finance and economics in academia, the private sector and the civil service, has guided the Chilean Ministry of Finance on fundamental aspects of investment policy. The respective mandates and investment policies of the two funds are clearly articulated and differentiated. Management and oversight is highly transparent, with information on fund managers, returns on specific investments and even how deposits and withdrawals are calculated, all made publicly available.

The existence of both the savings and stabilisation fund can be attributed to the high degree of fiscal dependence on copper revenues in Chile. Despite the development of agriculture, fisheries and light industry in recent decades, copper still constitutes around 60% of Chile's exports. The stabilisation fund contributes to the stability of the nation's budget that is, otherwise, hugely exposed on the volatility of its price; while the savings fund aims to use part of the copper-related revenues to fund anticipated future pension and social welfare liabilities.

II. Official mandate(s)

The two Chilean funds have clearly articulated and differentiated institutional mandates and objectives:

01. The PRF is a savings fund for pension and social welfare obligations. The fund specifically finances state-guaranteed solidarity pension benefits and contributions for the elderly and disabled;

02. The ESSF is a stabilisation fund and countercyclical tool that aims to smooth out government expenditures, allowing the government to finance fiscal deficits in times of low growth and/or low copper prices and to pay down public debt when necessary.

The Ministry of Finance has elaborated on the function of both funds. The PRF's role is to 'serve as a supplementary source for the funding of future pension contingencies'. The ESSF provides 'fiscal spending stabilisation, since it reduces its dependency on global business cycles and revenue's volatility derived from fluctuations of copper price and other sources'. Fiscal revenue shortfalls originating from economic downturns can be financed in part with resources from the ESSF, reducing the need for issuing debt.

From these institutional mandates, the Ministry of Finance has derived clearly articulated investment objectives. Given the more long-term nature of its liabilities, the PRF has a longer investment horizon, greater risk tolerance and less liquidity constraints than the ESSF. The investment mandates of the two funds are as follows:

01. Maximising the expected return, subject to a risk tolerance defined as a 95% probability that, in a given year, it will not suffer a loss of more than 10% of its value in US dollars. Given the size and timing of the liabilities it is designed to finance, the PRF has a medium to long-term investment horizon;

02. To maximise the fund's accumulated value in order to partially cover cyclical reductions in fiscal revenues while maintaining a low level of risk. Its risk aversion is reflected by the choice of an investment portfolio with a high level of liquidity and low credit risk and volatility, thereby ensuring the availability of the resources to cover fiscal deficits and preventing significant losses in the fund's value.

III. Source of funding

The rules and procedures for transferring funds to and from the Chilean sovereign funds, particularly the ESSF, are inextricably linked to the structural balance rule, Chile's more general fiscal rule. The process starts with two advisory Committees of the Ministry of Finance, who calculate trend GDP growth and the outlook for the copper price. These calculations are then used to estimate fiscal revenues for budget planning. An important characteristic of the Chilean fiscal rule is that it is not, contrary to Norway's fiscal rule, 'static', but rather 'dynamic' or 'contingent' on cyclical fluctuations in GDP and copper prices/revenues: the fiscal rule incorporates information on the business cycle as reflected by GDP deviations from trend and cyclical deviations of the price of copper from trend. In essence, the structural balance rule commits government to formulate fiscal policy as if GDP growth and copper revenues were at their long-term level.

Pension Reserve Fund (PRF)

A minimum of 0.2% of the previous year's GDP must be deposited into the PRF annually. If the effective fiscal surplus exceeds this amount, the deposit amount can rise to a maximum of 0.5% of the previous year's GDP. Additional deposits can be financed with funds from the ESSF at the discretion of the Minister of Finance. The PRF is currently capped at 900 million Unidades de Fomento (approximately $37 billion, as of March 2014), while its assets under management as of January 2014 were $7.4 billion. Table 1 shows the annual contributions and growth in assets under management of the PRF since inception.

Economic and Social Stabilisation Fund (ESSF)

The ESSF receives all remaining fiscal surplus, *after* deposits to the PRF (minus any funds used for public debt repayments or advance payments into the ESSF made in the previous year). The ESSF was established in 2007, with an initial contribution of $2.58 billion, derived from the old Copper Stabilisation Fund, which was replaced by the ESSF.

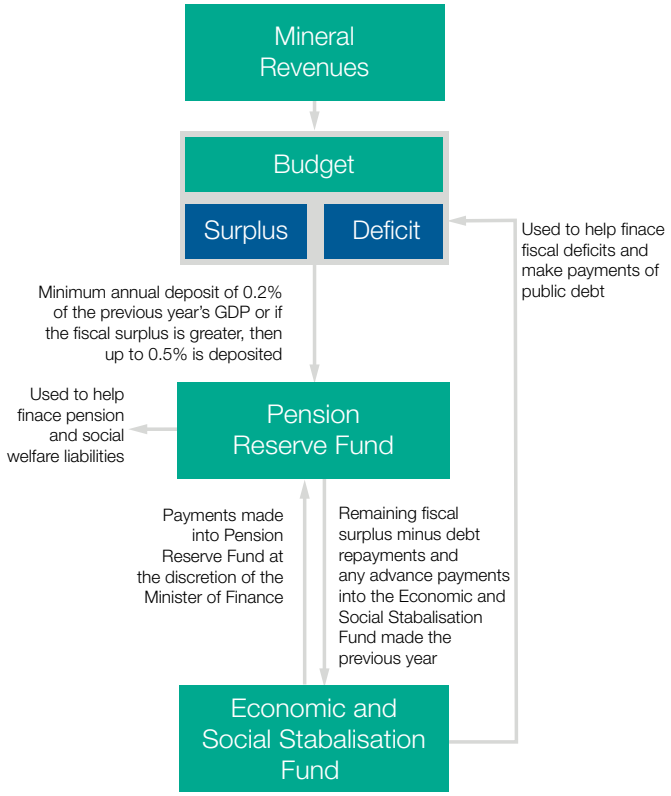
Table 1: Contributions and AUM growth of the PRF

YEAR	CONTRIBUTIONS (USD MILLIONS)	MARKET VALUE (USD MILLIONS)
2006	604.50	-
2007	736.40	1466.40
2008	909.10	2506.80
2009	836.70	3420.80
2010	337.30	3836.70
2011	443.30	4405.60
2012	1,197.40	5883.30
2013	1,376.80	7335.10
Total	6,441.00	7,335.00

Source: Chilean Ministry of Finance

The ESSF has grown considerably to a total market value of $15.6 billion as of January 2014. Current provisions established by the ministry of finance state that by 2021, if withdrawals from the PRF are not greater than 5% of pension spending that year, the PRF will cease to exist and its remaining funds will be transferred to the ESSF.

Figure 1: The flow of fiscal revenues between Chile's budget and sovereign wealth funds



Source: Chilean Ministry of Finance

IV. Liabilities

Pension Reserve Fund

Assets and/or investment proceeds from the PRF can be used exclusively to pay for pension and social welfare liabilities. Current provisions differentiate between a spending rule until 2016 and a new process after that date:

01. Until 2016, only the previous year's real return on the PRF may be withdrawn and spent;

02. From 2016 onward, annual withdrawals from the PRF cannot be greater than one-third of the difference between that year's pension-related expenditures and 2008's pension-related expenditures (adjusted for inflation).

Economic and Social Stabilisation Fund

Withdrawals from (and indeed deposits in to) the ESSF are determined through the structural balance rule, which allows for estimating fiscal revenues for budget planning and therefore, whether withdrawals are needed.

Funds can be withdrawn from the ESSF at any time in order to fill budget gaps in public expenditure and to pay down public debt. Funds can be withdrawn, at the discretion of the Minister of Finance, to finance annual contributions to the PRF. However, all withdrawals are subject to the structural balance rule. For 2014, for example, the Ministry of Finance has calculated the target structural balance to be a 1% deficit, indicating the need for withdrawals from the ESSF, rather than deposits.

V. Governance structure

The governance structure around Chile's sovereign funds is embedded in a highly transparent, rule-based and prudent fiscal framework (initiated in the mid-1990s and further developed by the Fiscal Responsibility Law of 1996). The funds are very much positioned as under the jurisdiction of the Ministry of Finance, which develops investment policies and publishes monthly, quarterly and annual reports on the funds' activities and performance. However, the CBC (as operational investment manager) and the financial Committee (appointed independent experts acting in an advisory capacity to the ministry) are also very important parts of the governance structure.

The PRF and the ESSF have an exceptionally high degree of transparency and accountability. Given the largely passive, index-based approach to the management of both funds, the internal governance structures and investment process of both funds are relatively simple.

External governance

i. Savings and spending rules

The rules governing flows in and out of Chile's two sovereign funds are set by the Fiscal Responsibility Law of 2006. The legal foundation of the strong rule-based savings and spending procedures means that there is little discretion vested in the hands of the president, Ministry of Finance or the parliament to change them.

On the savings-rule side, there is potentially some room for discretion and manipulation through the estimation of the two key variables in the rule: anticipated deviation from trend GDP and expected copper prices and revenues. However, in both cases, the estimation of these two variables is placed in the hands of dedicated independent expert Committees. The advisory Committee for GDP growth estimations consists of 16 members, while the Committee on copper revenues consists of 12 members – all are appointed by the Ministry of Finance. On the spending rule-side, the provisions described in the previous section are established in law, which limits the scope for discretion or abuse of the sovereign funds.

Contributions to and withdrawals from the ESSF and PRF are formalised through decrees issued by the Ministry of Finance.

ii. Public sector placement

The management of the Chilean sovereign funds is largely consolidated within the Ministry of Finance, although the operational investment of the funds is delegated to the Central Bank of Chile (with external asset managers managing around 35% of the funds' assets) under clear guidelines from the ministry. However, there are a number of other public institutions involved with the funds, particularly in an oversight capacity. The inter-institutional governance structure for the Chilean sovereign funds is shown in Figure 2, and the main functions of the public institutions around the funds can be summarised as follows:

01. The Chilean Congress passed the legislation authorising the funds and receives monthly, quarterly and annual reports from the Ministry of Finance;

02. The Comptroller General performs an audit of the Ministry of Finance's activities (including the fiscal rule and sovereign funds), and reports to the Congress;

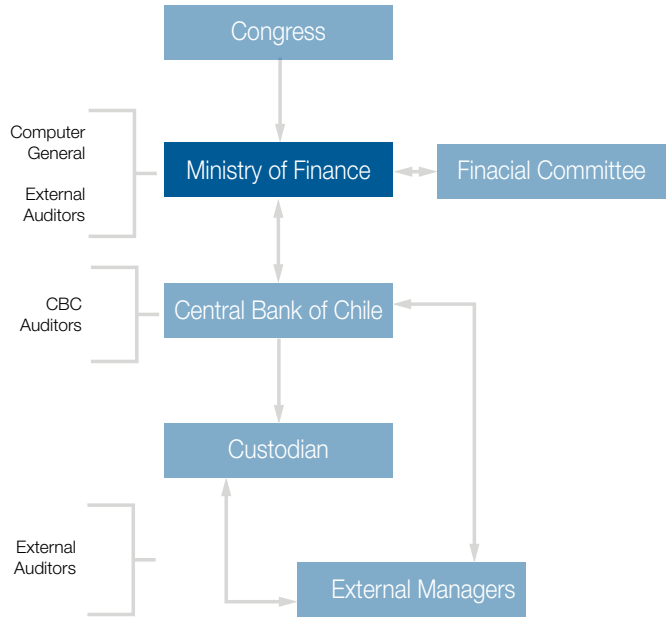
03. The Ministry of Finance determines investment and internal management policies for the sovereign funds, while the general treasury, Chile's revenue service, is responsible for accounting and preparing audited reports on the funds. The fiscal rules framework determines transfers of revenues to the sovereign funds, with significant input from expert panels appointed by the ministry. The General Treasury is also empowered to appoint external managers and custodians for the fund;

04. The Financial Committee is a panel of experts, appointed by the Ministry of Finance, which provides advice on the funds' management and investment policies. It releases its own annual reports and minutes from meetings, separate from those of the ministry;

05. The Central Bank of Chile manages the funds' investment portfolios, with a portion (currently around 35% of all assets of the PRF) delegated to external fund managers. The central bank also appoints and monitors the performance of external fund managers and custodians;

06. Independent External Auditors' reports are included in the report of the general treasury.

Figure 2: The inter-institutional reporting structure for the Chilean sovereign wealth funds



Source: Chilean Ministry of Finance

iii. Transparency and disclosure

The Chilean sovereign funds are among the most transparent in the world. Systematic reports and press releases are regularly published on the funds' investments, contributions, withdrawals and market value. The funds have a dedicated section on the ministry's website and the advisory financial Committee has its own extensive disclosure requirements (as discussed above).

By law, the Ministry of Finance is only required to prepare monthly and quarterly reports on the activity of the Chilean SWFs. However, since 2008, the ministry has also released an annual report containing detailed information on the funds' investment policy, performance and risks, as well as other activities associated with fund management. Starting in 2011, the annual report has included audited financial statements, prepared in accordance with international accounting standards. Reports are generally published in Spanish and English.

The Chilean authorities have also played a leading role within the international community of sovereign funds, notably by hosting discussions between the funds and the international financial institutions (through the International Forum of Sovereign Wealth Funds), which resulted in the Santiago Principles for generally agreed management principles and practices. The funds' annual report contains a detailed section addressing their compliance with these principles.

Internal governance

iv. Institutional governance

The Chilean sovereign funds have a simple internal governance structure, involving the Ministry of Finance, the CBC and the financial Committee. The roles, responsibilities and reporting lines in relation to the funds are established in law for the Ministry of Finance, and by ministerial decree for the central bank (issued in 2006) and the financial Committee (issued in 2007). Key elements of the framework between these three entities are as follows:

Ministry of Finance

- Legal owner of the funds and their resources;
- Decision-making power over all major issues related to the investment and management of the funds' resources;
- Establishing investment guidelines that identify eligible assets, specify the strategic portfolio allocation, define the benchmarks for performance evaluation and set investment and risk limits;
- The authority to delegate the operational management of the funds (to the central bank and/or to other external managers);
- The Ministry of Finance reports on the funds to the Chilean Congress and the general public through monthly, quarterly and annual reports;
- The general treasury (part of the Ministry of Finance) is responsible for the fund accounting and for preparing the audited financial statements. The ministry's budget office is responsible for the funds' operational budget.

Central Bank of Chile

- Direct management of part of the sovereign funds' portfolio;
- Tendering and delegating the management of part of the funds' assets to external managers in the name and on the account of the treasurer;
- Contracting the services of a custodian;
- Supervising and evaluating the performance of appointed external managers and custodian institutions;
- Reporting daily on investment positions to the Ministry of Finance, and preparing monthly, quarterly and annual reports on the management of the portfolios.

Financial Committee

- Consists of six independent members, appointed by the Ministry of Finance from the local community of macroeconomists and financial experts, and serving overlapping tenures of two years;
- The Committee meets every six weeks at the Ministry, which provides a secretariat that prepares technical reports on international financial conditions and financial performance of the funds for each meeting;
- The Committee reviews financial developments and their implications for the performance of the funds, and evaluates fund management by the CBC and external managers;

– It's main purpose is to issue recommendations about the funds' investment policies to the Ministry of Finance – these recommendations are not binding for the ministry, but have in practice carried great weight in the development of the funds' investment policies and guidelines;
– In addition to reporting to the Ministry, the Committee has a very extensive external reporting and disclosure schedule, including:
  – Reports to both houses and relevant Committees of the Chilean parliament;
  – Press releases and minutes from each meeting;
  – Its own annual report (independent from the Ministry's annual report on the funds);
  – Public disclosure of its recommendations to the Ministry of Finance.

v. Investment and risk management process

The Chilean SWFs have a very simple governance arrangement around the investment and risk management process. The Ministry of Finance produces and periodically updates investment guidelines for both funds, which contain all the critical investment and risk parameters: eligible assets, strategic asset allocation, performance benchmarks, and investment and risk limits. While the ministry therefore clearly 'owns' the investment strategy for both funds, the financial Committee actively and extensively advises it on these issues in a non-binding way. The central bank acts simply as an operational manager (or 'fiscal agent') on behalf of the ministry. Given the large passive, index-based investment strategy (small tracking errors), the central bank does not exercise significant discretion over the investment process.

VI. Investment style

Given their different objectives and functions, the PRF and ESSF have separate and distinct investment styles and greater strategy: the stabilisation fund (ESSF) naturally has a great concern for liquidity and low volatility, while the savings fund (PRF) has a more diversified portfolio that includes allocations to riskier assets. Both funds have highly passive investment strategies, focused on maintaining low tracking errors around their respective benchmarks. In addition to the continuous advisory and policy-development role of the financial Committee, the Ministry of Finance has determined and updated the investment strategies of both funds with the input of academic experts and international investment consulting firms, notably Mercer.

Pension Reserve Fund

The investment policy of the PRF incorporates the specific objective of maximising expected returns, while keeping risk within a 95% probability that the fund will not lose more than 10% of its value in US dollars in a given year. The investment horizon is described as medium- to long-term, given the size and timeline of the liabilities that the fund has to finance. The PRF investment policy stipulates a portfolio allocation of 48% in nominal sovereign bonds, 17% in inflation-indexed sovereign bonds, 15% in stocks, and 20% in corporate bonds. The implementation of this policy began in January 2012, and the allocation described above was in place by mid-March 2012. The CBC manages asset classes with sovereign risk exposure, while external managers selected in 2011 manage the stock and corporate bond portfolios. The asset classes defined under this policy are invested according to highly diversified benchmarks (see Table 1 below) and use a largely passive approach: the ex ante tracking error is capped at 50 basis points for the sovereign bond portfolio, 30 basis points for the stock portfolio and 50 basis points for the corporate bond portfolio.

Table 1: Strategic asset allocation and benchmarks of the PRF

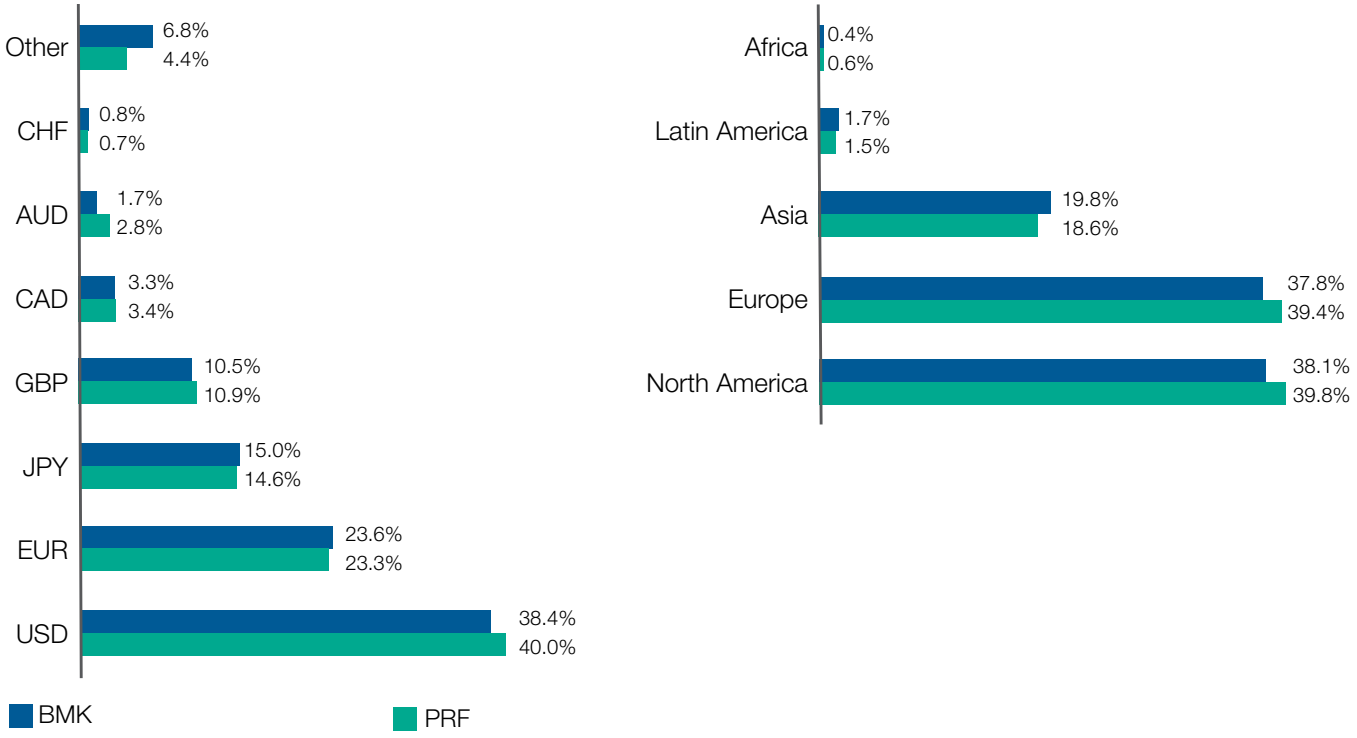
ASSET CLASS	PERCENT OF TOTAL	BENCHMARK
Sovereign and goverment related bonds[a]	48	Barclays Capital Global Aggregate: Treasury Bond Index (unhedged)
		Barclays Capital Global Aggregate: Goverment-Related (unhedged)[b]
Inflation-indexed sovereign bonds (real)	17	Barclays Capital Global Inflation-Linked Index (unhedged)
Corporate bonds	20	Barclays Capital Global Aggregate: Corporates Bond Index (unhedged)
Equities	15	MSCI All Country World Index ex Chile (unhedged with reinvested dividends)

Source: Chilean Ministry of Finance

Eligible instruments, issuers and currency/regional allocations (see Figure 3 below) are determined by the benchmarks used. A very limited use of exchange-traded funds, mutual funds and futures are allowed in order to facilitate benchmark tracking. Leveraging is not permitted, and the authorised use of forwards is confined exclusively to exchange rate hedging.

A portfolio rebalancing policy has been established to allow convergence to the asset allocation. The policy will be triggered whenever the PRF receives additional contributions and when any of the asset classes exceed their target ranges.

Figure 3: Currency and regional allocations of the PRF vs benchmark (% of total portfolio)



Source: Chilean Ministry of Finance

Economic and Social Stabilisation Fund

The investment policy of the ESSF centres on investment in fixed-income instruments in reserve currencies, which typically perform well in times of crisis. This facilitates its conversion into pesos (the currency used for most fiscal spending) when the resources are most needed. The main goal of the ESSF investment policy is to maximise the fund's accumulated value in order to partially cover cyclical reductions in fiscal revenue, while maintaining a low level of risk. This risk aversion is reflected in the choice of a highly liquid investment portfolio with low credit risk and low volatility, which ensures the timely availability of the resources to finance deficits and avoids significant losses in the fund's value.

The fund's strategic asset allocation consists of 30% in money market instruments, 66.5% in nominal sovereign bonds and 3.5% in inflation-indexed sovereign bonds (see Figure 5 below). Its currency allocation is 50% in US dollar, 40% in euro and 10% in yen. The fund's investment policy is very passive, with only marginal deviations from the strategic asset allocation allowed. According to this benchmark, 85% of the fund must be invested in sovereign instruments, with the following distribution by country: 42.5% in instruments issued by the US government, 34% in Germany and 8.5% in Japan. The remaining 15% is allocated to investment in banks, which are chosen by the CBC according to the issuer limits specified in the investment guidelines. Leveraging is not allowed in the fund, and the use of derivatives is limited exclusively to exchange rate hedging.

Table 2: Strategic asset allocation and benchmarks of the ESSF

BENCHMARK	USD	EUR	JPY	TOTAL
Money market	15.0	12.0	3.0	30.0
Merrill Lynch Libid 3 month average	7.5	6.0	1.5	15.0
Merrill Lynch Treasury Bills Index		6.0	1.5	15.0
Soveriegn bonds (nominal)	31.5	28.0	7.0	66.5
Barclays Capital Global Treasury: USA	31.5	-	-	31.5
Barclays Capital Global Treasury: Germany	-	28.0	-	28.0
Barclays Capital Global Treasuary: Japan	-	-	7.0	7.0
Inflation linked sovereign bond (real)	3.5	-	-	3.5
Barclays Capital U.S. Treasury: U.S. TIPS 1-10 years	3.5			
Total	50.0	40.0	10.0	100.0

Source: Chilean Ministry of Finance

China:
CIC and SAFE

▶ Key features

- Since 2006, China has been the world's largest holder of foreign exchange reserves. As at December 2013, it held $3.8 trillion worth of reserves including gold (at 2013 market price), more than double that of Japan which has the second largest holdings at $1.2 trillion;
- A majority of the reserves are held in US dollar denominated assets. They are managed by the State Administration of Foreign Exchange (SAFE), the investment arm of China's central bank, the People's Bank of China (PBoC);
- SAFE is headquartered in Beijing, with subsidiaries in Hong Kong, Singapore, New York and London. The PBoC is able to invest holdings abroad through these subsidiaries;
- In 2007, China established its first and only SWF, the Chinese Investment Corporation (CIC). The establishment of CIC largely came about as a compromise solution to the rivalry between the Ministry of Finance (MoF) and the PBoC for influence and control over the nation's massive stock of foreign exchange reserves;
- CIC is under the direct control of the State Council, the chief administrative authority of the People's Republic of China (PRC). The State Council is chaired by the premier of the PRC and has 35 members consisting of heads of government departments and agencies. The State Council appoints the CIC's Board of Directors and supervisors. The governance arrangements for SAFE are more opaque, but are also ultimately controlled by the State Council;
- Since 2011, CIC has consisted of two distinct entities, both wholly-owned subsidiaries to:
  - CIC International, established in 2011, with a mandate to manage and invest overseas assets;
  - Central Huijin Investment (Huijin), a holding company for domestic state-owned financial institutions and local strategic investment aimed at bolstering the national economy.

Fund snapshot

Year Established	1955 (SAFE) and 2007 (CIC)	
Assets Under Management (as at Dec 2013)	$300 billion (SAFE) and $652 billion (CIC)	
Source of Funds	Foreign reserves	
Portfolio at a glance (as at Dec 2013)	Public equities	40.4%
	Long-term investments	28.2%
	Fixed income securities	17.0%
	Absolute return investments	11.8%
	Cash and other equities	2.6%

I. Background: Economic and political context

To understand the distinct roles of the CIC and SAFE in managing China's foreign reserves, it is necessary to understand the rivalries between these organisations, as well as the impact of China's transition from a planned to a mixed economy on its approach to reserve management.

SAFE

SAFE was established in 1955 as the country's foreign exchange regulatory authority. It was, and still is, a subsidiary of China's central bank, PBoC. Before liberalisation of the Chinese economy in 1978, foreign exchange reserves were extremely limited. Under central planning in the Mao period, monetary policy was subservient to state planning. The PBoC was a state-owned commercial bank (SOCB) that took on the very limited functions of a central bank and did not have ministry status. It was subordinate to the Ministry of Finance, which had ownership rights over all the SOCBs.

1978-1983: Economic liberalisation and birth of the central bank

During the Cultural Revolution, the PBoC was absorbed by the Ministry of Finance, but as part of Deng Xiaoping's liberalisation of the economy in 1978, the PBoC was granted independence once again. PBoC continued to act as both a commercial and central bank until 1983, when it was officially designated as China's central bank.

SAFE's role has become significantly more complex since it became the country's foreign exchange regulator in 1979. At that time, China possessed just $167 million in foreign exchange reserves. In the 35 years since then, China's reserves have increased year-on-year and broke the $1 trillion mark in 1996 becoming the largest reserves globally in 2006[1]. In conjunction with these expanding reserves, SAFE has welcomed greater responsibilities as part of its effort to improve its stature within China's bureaucracy. In 1982, in addition to its delegated task of administration and management of China's foreign reserves, it assumed a leadership role within the PBOC. Other important tasks followed: responsibility for monitoring the foreign exchange swap market (1986); verifying import payments and improving the export payments verification process (1997) and more recently, approval of Chinese outward direct investment and monitoring repatriation of Chinese overseas investment profits (Balding and Campbell 2013, 47).

This assumption of greater responsibility was partly made possible by Chinese economic liberalisation, which opened up space for political contest among the various entities within China's financial policy architecture. Key public institutions exploited liberalisation, as well as China's fragmented political authority, to attempt to expand their influence. This period marked the beginning of a long-running rivalry between the PBoC and SAFE on the one side, and the Ministry of Finance on the other for control over the country's foreign reserves, a rivalry that helps explain the establishment of the country's first SWF almost thirty years later.

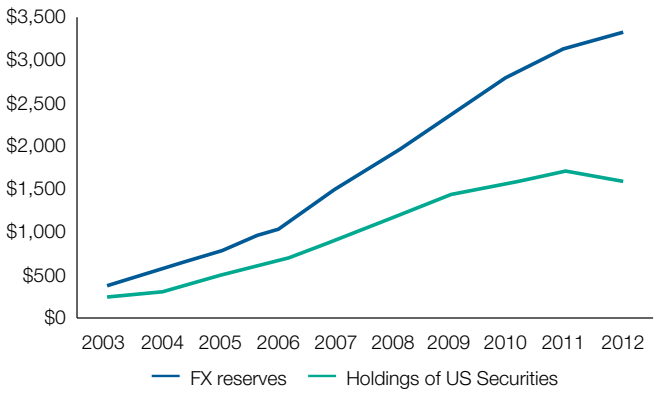
1. Balding, C. and Campbell, E. (2013). The Big Wallet of China: The China Investment Corporation and the State Administration of Foreign Exchange Reserves, in Sovereign Wealth Fund Report 2013, edited by Javier Santiso, ESADEgeo,KPMG and Invest in Spain (ICEX).

1997: Internationalisation

This bureaucratic rivalry and growing reserve levels influenced SAFE's expansion into overseas markets. In an effort to more effectively manage the rapidly expanding reserves, SAFE established satellite offices in Hong Kong, Singapore, London and New York. The first subsidiary was established in Hong Kong in 1997, one month before Great Britain handed Hong Kong over to China. The subsidiary was capitalised with approximately $20 billion to 'support and promote the development of Hong Kong's financial market'[1]. Named the SAFE Investment Company (SAFE IC), in its early life, the subsidiary operated as a minor outpost of SAFE, mimicking the conservative investment strategies of SAFE's Beijing headquarters, albeit with a crucial role of defending the value of the renminbi and Hong Kong's peg to the US dollar against international speculators[2].

Since then, SAFE has created additional overseas offices in Singapore, London, New York and Frankfurt. The role of these offices appears to be to help diversify China's foreign exchange reserves through higher return-seeking assets abroad. The satellite offices are managed by an 'affiliated institution' called the SAFE Investment Centre. SAFE does not refer to these offices as forming part of an investment tranche or strategy, but instead describes its overseas operations as an 'international investment platform with supporting points in Beijing, Singapore, Hong Kong, London, New York and Frankfurt'. Indeed, it did not even admit the existence of its Hong Kong subsidiary until 2008, when it was confronted with inconvertible evidence[2]. Despite its opaqueness, others have characterised this international diversification move as tantamount to SAFE 'quietly open[ing] up its own investment management portfolio'[3]. Figure 1 shows that the trend towards diversification commenced in 2007 as China began to move its reserves away from US Treasuries. While US Treasuries still constitute 'the lion's share of China's officially registered foreign exchange reserves, their proportion has declined from around 63% in 2003, to less than 50% in 2012'[4]. It seems plausible then that the creation of these overseas offices forms part of the scaffolding for a de facto investment portfolio within SAFE.

Figure 1: China's foreign exchange reserves and holdings of US Securities, 2003-2012 (US$ billions)



Source: Salidjanova, N. (2014). China's Foreign Exchange Reserves and Holdings of US Securities, USCC Economic Issue Brief No. 2, 21 March 2014.

1998-2003: Asian financial crisis, reform and diversification

During the state premiership of Zhu Rongji (1998-2003), a former PBoC governor, the status of the central bank was elevated considerably. Premier Zhu sought to reform China's banking sector to better equip it to serve the modern market economy that China's leaders had decided to create, a mission that was given great impetus by the Asian financial crisis. The crisis exposed the dangerous levels of undercapitalisation in China's state-owned banks as well as the scale of non-performing loans to similarly underperforming state-owned enterprises (SOEs) on the bank's balance sheets.

2. Jamil Anderlini, 'China investment arm emerges from shadows', Financial Times, 4 January 2008.
3. Balding, C. and Campbell, E. (2013). The Big Wallet of China: The China Investment Corporation and the State Administration of Foreign Exchange Reserves, in Sovereign Wealth Fund Report 2013, edited by Javier Santiso, ESADEgeo,KPMG and Invest in Spain (ICEX).
4. Salidjanova, N. (2014). China's Foreign Exchange Reserves and Holdings of US Securities, USCC Economic Issue Brief No. 2, 21 March 2014.

The first step in China's banking reform was recapitalisation of major SOCBs to raise their capital-adequacy ratios to the Bank for International Settlements (BIS) benchmark of 8%. In August 1998, the capital base of the four major state-owned banks – BoC, China Construction Bank (CCB), Industrial and Commercial Bank of China (ICBC) and the ABC – was more than doubled. The next step was to clean the non-performing loans from the balance sheets of the four banks. Reform of the banking sector gave the PBoC an opportunity to raise its status in the bureaucratic hierarchy at the expense of the Ministry of Finance since the PBoC as central bank was responsible for regulating and supervising the country's state-owned banks. However, the opportunity was not clear-cut, as the Ministry of Finance as 'owner' of the banks would profit from their reform. Ultimately, the financial reforms initiated by the central bank benefited the Ministry of Finance at the expense of the PBoC, whose balance sheet was weakened by the interventions, exacerbating the competition between the two institutions.

These short-term responses to the financial crisis had revealed deeper, structural problems in the Chinese economy, not least of which were the SOEs' balance sheets. But restructuring these entities was politically sensitive given the vast numbers of Chinese citizens employed by SOEs. At the same time, a different pressure emerged to force further banking reform. China's admission to the World Trade Organisation (WTO) in 2001 required it to lift the ban on entry to foreign-owned banks and strengthen its banking sector. The Ministry of Finance, as sole owner of the SOCBs could not recapitalise them by itself. Subsequent research revealed that the cost of cleansing the banks of non-performing loans was as much as 30% of 2005 GDP. Since the PBoC was not willing to intervene again to its detriment, the government was forced to initiate a radical overhaul of bank ownership. This allowed it to meet the conditions of WTO membership without embarking on a controversial clean up of the SOE sector. A 2003 Party Congress established the Central Leading Group on Reforming the Shareholding of SOCBs (CLG) to oversee the bank ownership overhaul.

2003: Birth of Huijin Central, a quasi-sovereign fund

Given the CLG administration's dominance by past and current PBoC officials, there was little surprise when the CLG decided to restructure the banks in a manner favourable to the central bank. In December 2003, the CLG decided to make PBoC a major shareholder of the SOCBs. Before the plan could be executed, a shell company had to be established to bypass a Chinese law that prohibited PBoC from owning any commercial banks. This was the genesis of the Central Huijin Investment Corporation (Huijin), a holding company set up as a 'zhongyang' corporation, meaning it was embedded within a central ministry. Huijin was not given its own offices, but was located within SAFE. The inaugural chief executive officer, Guo Shuqing, was a deputy governor of PBoC and head of SAFE. Five of its seven Directors and two of the three members on its Board of Supervisors were from SAFE or PBoC.

SAFE capitalised Huijin with $45 billion of foreign exchange reserves. This was then channelled as equity to the BoC and CCB, two of the four state-owned banks that needed recapitalisation. The Ministry of Finance wrote down its investments in these banks, making Huijin the sole owner. SAFE transferred additional foreign exchange reserves to Huijin as equity and a year later, Huijin bought an 8% stake ($3 billion) in the Bank of Commerce, followed in 2005 by a $15 billion investment in another of the four SOCBs, the ICBC, making it an equal shareholder with the Ministry of Finance. The recapitalisation of these banks through Huijin increased PBoC's influence over the banking sector at the Ministry of Finance's expense.

Since Huijin was established with foreign exchange reserves specifically to recapitalise the SOCBs, it can be regarded as a quasi-SWF, even though China resists that classification. Whatever its appropriate classification, using foreign exchange reserves to recapitalise the bank served a number of national policy objectives at the time:

– Reducing the amount of official foreign reserves in SAFE, which helped minimise the external pressure to appreciate the renminbi;

– Avoidance of an increased fiscal deficit if the government were forced to use general revenues to capitalise the underperforming state-owned banks.

2005-2007: Pressure to establish an official sovereign fund

But larger forces were at work, revealing the inadequacy of Huijin as a satisfactory response to China's continued rapid accumulation of foreign exchange reserves. In 2005, there was a massive jump in China's annual net exports, from 6% to 24.1% of GDP, which significantly increased the influx of US dollar reserves and raised pressure for renminbi appreciation as these vast sums of foreign reserves could not be used for bank recapitalisation alone. China had formally discontinued pegging the renminbi against the US dollar that year and instead pegged the renminbi against a basket of currencies. Over the past five years, the US dollar had depreciated 31% on a trade-weighted basis against the other major industrialised economies, reducing Beijing's purchasing power. The depegging immediately appreciated the renminbi by 2.1% against the US dollar.

There was disagreement among the major economic players – the Ministry of Finance, the PBoC and other parts of the bureaucracy – on whether to further rapidly appreciate the renminbi. The PBoC, as owner of the state-owned banks through Huijin, resisted further renminbi appreciation, since this would lower the renminbi value of the banks' substantial amount of US dollar-denominated assets from their initial PBoC capitalisation. This, in turn, would risk reversing the bank's now vastly improved capital ratios. The PBoC was also weary of eroding the value of its enormous, growing stock of foreign currency assets as that would render it dependent on a capital injection from the Ministry of Finance.

Discussions regarding the need to purchase assets abroad intensified. Offshore investments would help spend and de-accumulate the stock of foreign exchange reserves and could, in turn, lower the pressure for renminbi appreciation. But to invest foreign exchange reserves overseas and/or in non-finance sectors meant the PBoC going well beyond its central bank remit, opening the door for other parts of the bureaucracy to challenge PBoC's monopoly on the management of the country's foreign exchange reserves.

The Ministry of Finance argued for the establishment of a new independent sovereign fund arguing that SAFE, the arm of the PBoC that managed the foreign exchange investments, lacked the skills to make more diversified, higher risk investments. They also argued for the transfer of Huijin Investments to this new entity. Since Huijin was restricted in the type of investments it could make, a new structure was needed to allow greater investment choice of foreign exchange reserves. Huijin could no longer be solely 'owned' by PBoC once other bureaucratic players became involved.

The PBoC resisted these calls, not wanting to lose control over the large pot of foreign reserves. To prove that it was up to the investment task, in early 2007, SAFE allocated up to 15% of its reserves to higher-return, non-debt assets. Through the Hong Kong subsidiary SAFE IC, it took small equity positions in some of the world's largest public companies and by mid-2007, it had disclosed holdings of up to $22.1 billion in FTSE 100 companies, equally 0.75% of the index's total market capitalisation. These investments marked the beginning of SAFE's 'investment portfolio', tasked with pursuing higher returns than permitted by typical reserve management strategies. Such portfolios are similar in objective and strategy to those held by Saudi Arabia's Monetary Agency and the Hong Kong Monetary Authority.

Chinese Investment Corporation (CIC)

Despite SAFE's efforts and protests by the PBoC, a new sovereign fund, the CIC, was set up in September 2007. The establishment of a new fund, separate to SAFE, which controlled Huijin, and the Ministry of Finance, was largely a result of the desire to find a compromise solution to the ongoing rivalry between the two organisations for control of the country's financial assets. However, this rivalry cannot explain the timing of the CIC's establishment in 2007, four years after the proposal for an SWF had first been floated. Instead, developments in China's foreign reserves policy during 2003-2007 were the key influence on the timing of the CIC's creation. In particular, the depegging of the renminbi in 2005, China's ascent to holder of the largest official reserves globally in 2006, and the continued depreciation of the US dollar against the renminbi and other major currencies, added major impetus to the case for foreign reserves to be invested offshore in assets other than foreign government and agency debt.

While SAFE lobbied for a mandate expansion to Huijin or the creation of a similar entity under the remit of one of its international subsidiaries to implement this offshore investment strategy, concern was growing within China's bureaucracy over the PBoC's inherently conflicting dual role as both bank shareholder (through Huijin) and national policymaker and regulator. The Ministry of Finance proposed that its finance department should take over the ownership and management rights of state-owned financial assets from Huijin. PBoC responded that funds for Huijin's investments in the banks came from foreign exchange reserves, which were purchased with the central bank's liabilities. PBoC could not remain a significant bank shareholder, but it was not prepared to hand over control of Huijin to the Ministry of Finance.

All these factors culminated in the final decision to establish CIC at the National Finance Work Meeting in January 2007. Since the central bank would not agree to relinquish control over the management of the country's foreign exchange reserves to the Ministry of Finance, the CIC was placed directly under the control of the State Council as a compromise, with neither PBC, nor the Ministry of Finance, having ownership rights. Although the Ministry of Finance was not made owner of CIC, officials with Ministry of Finance backgrounds dominated its Board of Directors (see Governance section). CIC was established with a clear mission to diversify China's foreign exchange investments and to seek maximum returns for its shareholder within acceptable risk tolerance.

2011: CIC reorganisation – CIC International and Central Huijin

In 2011, CIC formalised the separation of CIC International responsible for managing the fund's global portfolio and Central Huijin Investment, which holds controlling stakes in China's main financial institutions. CIC International and Central Huijin have separate Boards of Directors, supervisors and investment managers, but they are both wholly owned subsidiaries of the CIC.

This same year saw the extension of the CIC's investment horizon to 10 years and the introduction of annualised rolling returns, as the basis for benchmarking performance, underscoring the commitment of the fund to long-term returns. CIC now invests according to an endowment model approach to asset allocation.

II. Official mandate(s)

SAFE

The basic purpose of SAFE is to manage China's $3.8 trillion foreign reserves. As an institution, SAFE's main responsibilities are to draft policies and regulations and to supervise and inspect foreign exchange transactions, including exercising control over international commercial borrowings, issuing foreign-currency bonds, and managing the overall foreign-debt exposure of Chinese entities.

The full institutional mandate is as follows:

01. Design and implement the balance of payments statistical system in conformity with international standards and enforce the balance of payments statistical reporting system;

02. Analyse the balance of payments and foreign exchange positions, provide policy proposals with the aim of achieving an equilibrium balance of payments position, and conduct feasibility studies on the convertibility of the renminbi under the capital account;

03. Draft rules and regulations governing foreign exchange market activities, overseeing the market conduct and operations, and promoting the development of foreign exchange market; analysing and forecasting the foreign exchange supply/demand positions and providing the PBoC with propositions for the formulation of exchange rate policy;

04. Promulgate regulatory measures governing foreign exchange transactions under current account and supervise the transactions accordingly; monitor and regulate the foreign exchange account operations both in China and abroad;

05. Manage and monitor foreign exchange transactions under capital account, including inward and outward remittance and payments;

06. Manage foreign exchange reserves of the country in accordance with relevant rules;

07. Draft foreign exchange administration rules, examining the domestic entities' compliance, and penalise institutions engaging in illegal practices;

08. Participate in relevant international financial activities;

09. Perform other duties and responsibilities assigned by the State Council and the PBoC.

Like other central banks, its investment mandate is to manage its reserves for safety and liquidity to preserve the reserve's value. The majority of its holdings are managed according to these principles and are held in US dollar-denominated assets (around 50%), with only a small portion (estimated $300 billion) seeking a higher return through its subsidiaries in Hong Kong, Singapore, London and New York.

China Investment Corporation (CIC)

The CIC's basic mission is to diversify China's foreign exchange investments and to seek maximum returns for its shareholder, the State Council, within acceptable risk tolerance.

To fulfil this purpose, CIC's institutional mandate is to seek maximum returns for the shareholder within acceptable risk tolerance. The fund seeks to fulfil this purpose through two separate subsidiary entities, each with their own distinct institutional mandates:

01. CIC International: established in 2011, to invest assets internationally;

02. Central Huijin Investment: purchased in 2007, to manage CIC's stake in domestic state-owned financial institutions and invests at home to bolster the national economy.

The CIC's investment mandate is to seek maximum returns for the shareholder within an acceptable risk tolerance, targeting a real return of 6%. The initial investment mandate involved a combination of short-term return generation and medium to long-term capital preservation. The mandate to preserve capital formed part of the CIC's legal obligation, while the requirement to provide positive short-term returns was a product of the politics around the fund's establishment. Generating quick returns would help justify CIC's establishment as a separate fund that SAFE had resisted. In 2011, the short-term focus was officially replaced with a focus on long-term returns, as CIC's Board of Directors extended the investment horizon to 10 years and adopted rolling annualised return as a benchmark to evaluate performance.

III. Source of funding

SAFE

As the management arm of China's central bank, SAFE's source of funding is foreign exchange reserves. In China, these are generated primarily from substantial trade surpluses. At the end of 2013, SAFE's total reserve holdings amounted to $3.8 trillion, currently the largest in the world. SAFE has a little-known subsidiary in Hong Kong, which has invested heavily in foreign equities. SAFE Investment Company (SAFE IC) was established in 1997, with a registered capital of HK$100 million (US$20 billion).

CIC

CIC was initially funded with registered capital of $200 billion. At the time, this accounted for just 15% of China's reserves. Following approval of the 10th National People's Congress, the Ministry of Finance issued 1.55 trillion Renminbi in government bonds, underwritten by the state-owned ABC and used these funds to purchase foreign reserves from PBoC for injection into CIC as registered equity capital. The Ministry of Finance bonds used to fund CIC were issued in eight tranches at terms of 10 years and 15 years, with interest ranging from 4.3% to 4.7%. CIC has to repay this debt in renminbi, even though the currency in which CIC expects to earn its returns overseas is US dollars. This has posed challenges as the renminbi has further appreciated against the dollar.

That CIC's seed capital took the form of debt rather than equity is significant in two senses:

01. It helped signal that the Ministry of Finance was not the legal owner of CIC;

02. It has proven expensive for the CIC to pay back this capital and the interest on the loan.

Former CIC Chairman Lou stated, soon after the founding of CIC that, based on the debt owed to Ministry of Finance, the fund 'needs to make 300 million renminbi [US$46.6 million] on an average workday' to cover interest payments to the Ministry of Finance. Since then, CIC has received two further capital injections from its rival SAFE: $30 billion in 2011 and $19 billion in 2012. These subsequent injections have been reported to be in the form of debt.

IV. Liabilities

SAFE has the standard liabilities of a central bank. Any deposits placed with SAFE by commercial banks or other institutions must be repaid and interest on these deposits serviced. The foreign reserves must be available to back the monetary base. There are no immediate liabilities on the excess foreign exchange reserves diversified into the higher return-seeking portion of SAFE's investment portfolio.

CIC has to pay dividends, either to the State Council or the Ministry of Finance, as well as service its interest payments on its start-up capital to the Ministry of Finance. There is some ambiguity here, as it has been reported that, in 2009, the CIC and Ministry of Finance agreed to classify the $200 billion capitalisation as assets, rather than debt, in an effort to mitigate the debt burden on CIC. If this information is accurate, then the Ministry of Finance is now a partial shareholder in CIC, entitled to dividend payments.

V. Governance structure

External governance

i. Savings and spending rules

SAFE

Injections into and withdrawals from SAFE are not rule-governed; however, as the investment arm of the central bank, SAFE enjoys a regular income stream, managing 100% of the country's foreign reserves. Internal transfers from SAFE to its international subsidiaries appear to be opportunistic, driven by strategic considerations rather than any standing transfer rules. For instance, from 2007 onwards, SAFE allocated a higher proportion of its assets to its international subsidiaries, when trying to establish its credibility as a manager of higher return-seeking investments – to prevent the establishment of a separate sovereign fund that would gain control of a portion of its foreign reserves.

CIC

The CIC is also not governed by a rule-based approach to its savings and spending. As a result, the CIC has no regular income stream. Instead, its seed capital and ongoing injections of capital are determined on an opportunistic basis by China's economic policy elite. It was initially capitalised on 29 September 2007, when the Ministry of Finance swapped 1.55 trillion renminbi bonds with the PBoC, in exchange for US$200 billion of foreign exchange assets, which it then injected into CIC in the form of a loan. Since it was a loan and not a capital injection, CIC has to pay interest on the US$200 billion.

Of the initial US$200 billion, CIC used US$67 billion to purchase Huijin from PBoC, which became a subsidiary of CIC. Another US$67 billion was originally planned for use to restructure and recapitalise two banks – the China Development Bank (CDB) and ABC, leaving the remaining US$66 billion for investment overseas. The amount allocated for bank restructuring was later reduced and the amount allocated for investment overseas was increased to slightly more than US$100 billion. Since those initial injections, CIC has received a further US$49 billion in capital from the government.

ii. Placement and reporting lines within the public sector

SAFE

SAFE is treated as equivalent to a vice-ministry agency within China. Therefore, the head of SAFE has always been a Deputy Governor of the PBoC. The legal foundation of SAFE is the Law on the People's Bank of China 1995, which specifies that the PBoC owns, administers and manages the country's foreign exchange reserves. PBoC delegates the tasks of administration and management to SAFE.

CIC

While the CIC was established as a standalone entity, with its own dedicated enabling legislation, the organisation is under the direct control of the State Council, the highest executive organ of state power in China, chaired by the Premier.

Neither the PBoC nor the Ministry of Finance have ownership rights over CIC. This was a result of a compromise struck at the time of CIC's establishment. The PBoC strongly resisted relinquishing control over its management of the country's foreign exchange reserves to the Ministry of Finance. Despite CIC's Ministry rank alongside PBoC and the Ministry of Finance, in practice it is lower in the pecking order of public finance management within China.

iii. Transparency and disclosure

SAFE

SAFE is not a particularly transparent institution, relative to other central banks. The only information available about the portfolio is total size, while portfolio composition is not published, nor is investment performance. Public information concerning the organisational structure of this institution is also limited. SAFE did not publicly admit the existence of its Hong Kong subsidiary until 2008 when it was confronted with incontrovertible evidence[5].

Part of the challenge surrounding SAFE's transparency stems from the fact that China is not a participant in the IMFs Reserve Template as the international disclosure standard for international reserves is known. The Reserves Template was designed to encourage countries to be more transparent and disciplined in their release of information about international reserves and to provide more confidence that those reserves were readily available to meet the country's international obligations. It was not designed to inform the public about investment strategies, so it does not distinguish between reserves held in securities in the form of bonds or equities, or identify equity stakes that are significant and might be controlling. The investments of the SAFE are, therefore, not required to be disclosed under any international obligations to which China adheres.

5. Jamil Anderlini, 'China investment arm emerges from shadows', Financial Times, 4 January 2008.

CIC

By comparison, CIC is more transparent. CIC started off wary of too much transparency, with its first chief investment officer, Lou Jiwei, quoted in late 2007 saying: '[w]e will increase transparency without harming the commercial interests of CIC. That is to say it will be a gradual process. Transparency is a really tough issue. If we are transparent on everything, the wolves will eat us up'[6]. However, CIC stayed true to its word and increased disclosures. It has released an Annual Report for each year of its existence, since 2008. Over that period, the contents of the report's disclosures have improved steadily, resulting in CIC's improved scoring on the Truman ScoreBoard.

Internal governance

iv. Institutional governance

SAFE

SAFE operated as an independent organisation until 1998 when it was folded into PBoC as part of a movement to strengthen the central bank. Today, SAFE functions as a bureau with vice-ministerial rank under the PBoC. SAFE is headquartered in Beijing. Management of reserves is centralised in the Beijing head office, which consists of eight functional departments, with assistance from two foreign administration centres, in Beijing and Chongqing and 34 local bureaus. Table 1 sets out the eight departments at SAFE's headquarters:

01. General Affairs Department (Policy and Regulation Department);

02. Balance of Payments Department;

03. Current Account Management Department;

04. Capital Account Management Department;

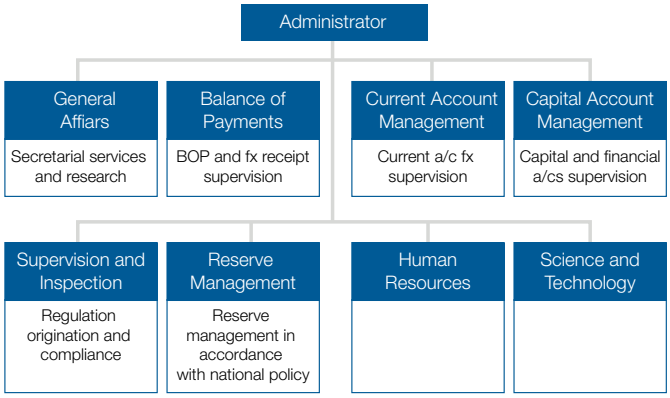
05. Supervision and Inspection Department;

06. Reserves Management Department;

07. Human Resources Department (Internal Auditing Department);

08. Science and Technology Department.

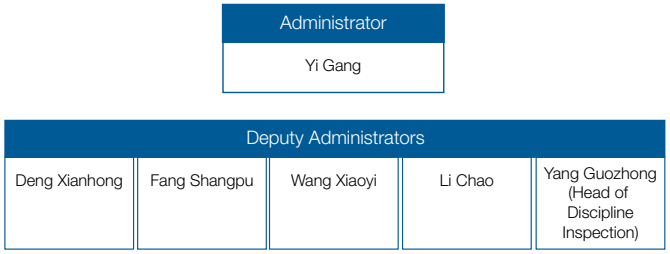
Table 1: Overview of SAFE's head office structure



Source: SAFE

SAFE's primary governance body is the Committee of administrators and deputy administrators. As Table 2 below shows, head Administrator Yi Gang is assisted by five deputy governors of the PBoC.

Table 2: SAFE's internal governance



Source: US-China Council for Business

6. Truman, E. (2010). Sovereign Wealth Funds: Threat or Salvation? Washington: Peterson Institute for International Economics, page 100.

CIC

CIC has a three-tiered governance system consisting of a:

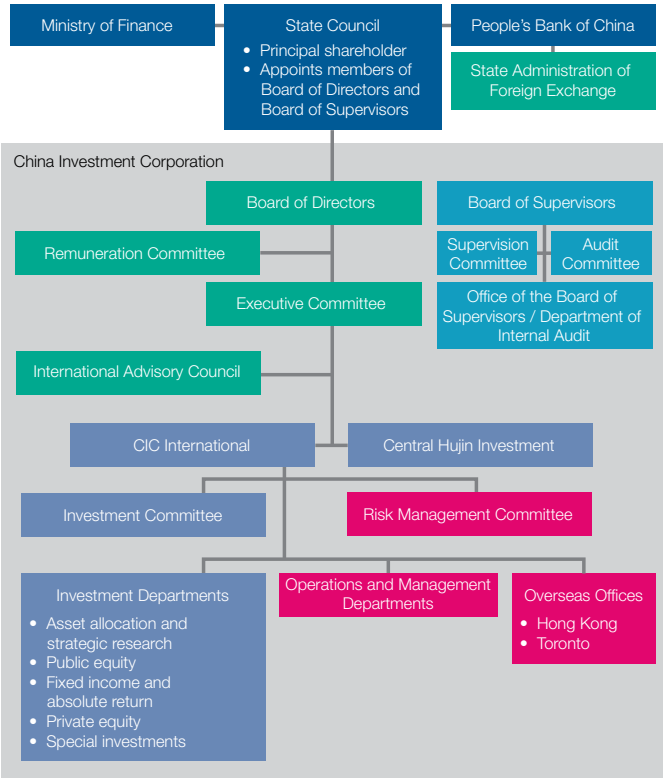
– Board of Directors, with nine members (used to be 11);

– Board of Supervisors with five members;

– Executive Committee with nine seats.

As reflected in Table 3 below, the State Council appoints the Board of Directors and supervisors.

Table 3: CIC organisational and governance structure



Source: Chinese Investment Corporation

Board of Directors

The CIC Board of Directors is mandated to oversee the company's operation and overall performance. The Chairman of the Board is also Chief Executive Officer. The other nine Directors are comprised of executive, non-executive, independent and employee appointments. Board appointments are heavily linked to the Ministry of Finance and China's political establishment. For although the Ministry of Finance was not made outright owner of CIC, it was given managerial control over the fund and its officials dominated the initial senior leadership ranks of CIC, as they still do today (See Table 4). The influence of the Ministry of Finance is striking given the CIC's Articles of Association allow five major government agencies – including the PBoC and SAFE – to nominate one non-executive Director to CIC's Board of Directors as a placatory measure. Despite this, the Ministry of Finance's influence remained strong with the inaugural chairmen of CIC's Board of Directors and Board of supervisors both former Ministry of Finance officials and in those positions from 2007-2013[7]. The current Chairman and Chief Executive Officer of CIC, Ding Xuedong previously served as the deputy general of the State Council and held various positions in the Ministry of Finance. The rest of the Board are also largely from the financial bureaucratic elite with allegiance to the Ministry of Finance (See Table 4).

7. Koch-Weser, I. and Haacke, O. (2013). China Investment Corporation: Recent Developments in Performance, Strategy, and Governance, U.S.-China Economic and Security Review Commission, 13 June 2013.

Table 4: Current CIC Board members

CIC POSITION	NAME	CURRENT / FORMER ROLES OUTSIDE CIC	ALLEGIANCE
BOARD OF DIRECTORS			
Chairman and CEO	Ding Xuedong	Former Deputy Secretary General of the State Council; former Vice Minister of Finance	MOF
Vice Chairman, President and CIO	Li Keping	Former Vice Chairman, National Council for the Social Security Fund	MOF
Independent Director	Zhang Xiaoqiang	Former Vice Chairman, NDRC; Former Director General at the State Planning Commission	MOF
Non-executive Directors	Hiu Zucai	Current Vice Chairman, NDRC	MOF
	Wang Baoan	Current Vice Minister of Finance	MOF
	Zhang Xiangchen	Current Assistant Minister in Ministry of Commerce	MOF
	Hu Xiaolian	Current Deputy Governor, PBOC	PBoC
	Fang Shangpu	Current Deputy Administer, SAFE	PBoC
Employee Director	Li Xin	Former Deputy Director, Commission for Science, Technology and Industry for National Defense; division chief at the Ministry of Finance	MOF
TOTAL:	9 Directors		
BOARD OF SUPERVISORS			
Chairman of Board of Supervisors	Li Xiaopeng	Former Vice President of ICBC	MOF
Supervisors	Dong Dasheng	Current Deputy Auditor General, National Audit Office	–
	Zhou Mubing	Current Vice Chairman, China Banking Regulatory Commission	PBoC
	Zhuang Xinyi	Current Vice Chairman, China Securities Regulatory Commission	PBoC
Employee Supervisor	Cui Guangqing	Former Director General, Information and Postal Audit Office, of the National Audit Office	–
TOTAL	5 Directors		

Sources: Koch-Weser, I. and Haacke, O. (2013). China Investment Corporation: Recent Developments in Performance, Strategy, and Governance, U.S.-China Economic and Security Review Commission, 13 June 2013, updated with CIC Annual Report 2013.

Board of Supervisors

The Board of Supervisors has the authority to and responsibility for overseeing the company's accounting and financial activities. The supervisory Board also has the mandate to monitor the ethical conduct of the members of the Board of Directors and senior executives. The Board of Supervisors has five seats and is composed of a Chairman, three supervisors and an employee supervisor, appointed by the State Council.

Executive Committee

The Executive Committee is responsible for CIC's daily operations. As mandated by the Board of Directors, it has full operational independence, and the authority to make individual investment decisions and operational decisions. It assumes full accountability to the Board of Directors and to the State Council.

v. Investment and risk management process

SAFE

Within SAFE's head office, set out above in Table 1, the Reserves Management Department, also known as the Central Foreign Exchange Business Centre, consists of more than 20 divisions, divided along functional bases covering asset allocation, risk management, accounting and compliance. There is also an external manager division to deal with outside mandates and a section to deal with the overseas subsidiaries.

CIC

At CIC, the investment and risk management process is described as 'scientific, disciplined and effective' (CIC Annual Report 2013). Relative to other sovereign funds, it involves an extensive machinery of decision-making bodies with influence over investment policy (See Table 5).

The Board of Directors, as mandated by objectives and broad policy set by the State Council, sets investment strategy and operational guidelines. Its mandate also includes:

01. Deciding how to implement such strategies;

02. Identifying major issues that need to be reported to the State Council;

03. Appointing, and if required, authorising the removal of management;

04. Delegating responsibilities and establishing committees as necessary.

An Investment Committee determines investment policies in line with the guidelines defined by the Board of Directors and Executive Committee and evaluates and approves investment proposals submitted by the investment departments. It consists of:

01. Chairman and Chief Executive Officer;

02. Vice-Chairman and President;

03. Executive Vice-President and Chief Investment Officer;

04. Executive Vice-Presidents;

05. Chief Strategy Officer;

06. Chief Risk Officer;

07. Heads of the department of asset allocation and strategic research;

08. Four functioning investment departments;

09. Department of risk management;

10. President of CIC International (Hong Kong).

The Investment Committee convenes weekly (with additional ad hoc sessions if needed) and makes investment decisions independently. Before submission to the Investment Committee, investment proposals are reviewed at a pre-Investment Committee meeting chaired by the CIO. Investment teams are responsible for implementing the decisions.

Decision making flow chart

Board of Directors	– Formulate mid and long-term strategies; – Decide on asset allocation plans; – Set return targets; – Set investment horizon.
Executive Committee	– Conduct research and decide on major business and operationsal issues of the company.
Investment Committee	– Formulate the company's investment strategy and policy, review and approve investment plans proposed by investment departments based on guidelines set forth by the Board of Directors and the Executive Committee; – Set up and authorise other investment decision-making bodies as needed; – Exercise other investment management functions as authorised by the Executive Committee; – Review other issues the Committee considers necessary.
Pre-Investment Committee Meeting	– Review proposals to be submitted to the Investment Committee; – Make investment decisions within the mandate fo the Investment Committee; – Give directions on specific issues in the investment process; – Assess regularly performance and progress of invested or approved projects; – Discuss major market developments and investment issues with relevand departments.

Investment Departments	Supporting Departments

– Asset Allocation and Strategy Research;
– Public Equity;
– Fixed Income and Absolute Return;
– Private Equity;
– Special investments:
  – Construct substrategies and manage portfolio under the asset allocation and risk management framework;
  – Make investment decisions as authorised.
	– Risk Management Departments – provide opinions on market, credit and operations risks in the process of investment and operation;
	– Legal and Compliance Department – ensure that the investment is made in accord with laws and regulations of the recipient countries and regulations;
	– Public relations and International Cooperation Department – provide opinions concerning country risk and reputational risk.

Source: CIC Annual Report 2013

For oversight of risk, there is Risk Management Committee comprising of:

01. The Chairman and Chief Executive Officer;

02. President and related executive Vice-Presidents;

03. Chief Strategy Officer;

04. Chief Risk Officer;

05. Heads of the Department of Risk Management, Department of Legal and Compliance, Department of Public Relations and International Cooperation, Department of Asset Allocation and Strategic Research, Department of Investment Operations, Department of Finance and Accounting, Department of Internal Audit and General Office.

VI. Investment style

Given their different objectives and functions, the SAFE and the CIC have distinct investment styles and strategies. According to the Overview of Management of China's Foreign Reserves, SAFE adheres to three principles in portfolio management: safety, liquidity and value appreciation. It is focused on maintaining the safety of China's foreign reserves as its utmost task. In contrast, the CIC has a diversified portfolio consisting of higher return, higher-risk assets in line with its mandate to generate better returns through riskier investments on a portion of the country's foreign reserves.

However, since CIC's establishment, SAFE has used its subsidiary offices in Hong Kong, Singapore, London, New York and Frankfurt to diversify away from low-risk, liquid securities, albeit on a discrete basis, to demonstrate that it, too, can achieve high returns on reserves. The most high profile is the Hong Kong subsidiary, SAFE IC.

SAFE

Prior to the financial crisis and the ascent of China to become the largest holder of foreign reserves globally in 2006, SAFE held up to 70% of its portfolio in US Treasury bonds with approximately 30% in other foreign reserve currencies, including the euro, sterling, US dollar and Japanese yen, as well as some government agency debt. As part of this strategy, SAFE's international subsidiaries concentrated on replicating the portfolio at the Beijing head office, investing in safe and liquid assets. This initial portfolio consisted entirely of fixed income assets.

2007: Competitive diversification

In 2007, the portfolio was diversified following concern about the depreciation of the US dollar (a large proportion of China's registered foreign exchange reserves were held in US Treasuries) against other major currencies over the previous five years and to help prove that a separate sovereign fund for seeking higher returns on foreign reserves was unnecessary. A small portion of the portfolio, about 15% (roughly $300 billion), was invested in higher return, non-debt assets using an index replication strategy, with a substantial increase in capital allocated to the international subsidiaries.

The first investments occurred through SAFE IC in Hong Kong, since SAFE as an arm of the central bank is prevented from investing abroad. SAFE IC began building small positions in large-cap equities as a hedge against currency depreciation of its US dollar holdings. By mid-2007, SAFE had disclosed holdings in FTSE 100 companies worth $22.1 billion and had also invested widely in the US and Europe. SAFE IC rapidly accelerated this higher-return seeking activity in late 2007 and early 2008, taking larger equity stakes of more than 1% in global companies. It acquired $176 million stakes in Australia's three largest banks, ANZ, the Commonwealth Bank and National Australia Bank in January 2008, followed by a 1% stake in UK oil producer BP and 1.6% in French oil producer Total. At the same time, SAFE increased the risk profile of its traditional fixed income portfolio to boost returns. It became the biggest foreign investor in US government mortgage lenders Freddie Mac and Fannie Mae, with a $527 billion stake.

SAFE also commenced investing in alternatives in 2008, allocating $2.3 billion to US private equity TPG Capital to its sixth fund dedicated to global buyouts.

2008: Financial crisis

The combination of the subprime mortgage crisis and the full onslaught of the global financial crisis in September 2008 caused massive losses in the fixed income and equity portfolios, as well as the private equity exposure. SAFE suffered an estimated $80 billion loss in its equity holdings as equity markets crashed, as well as huge losses in its debt portfolio, as a result of the massive exposure to US government agency debt. It was forced to retreat rapidly from these holdings, slashing its exposure to US government agency debt and limiting its equity strategy to a hedge against currency fluctuations. Part of this defensive withdrawal was also necessitated by CIC's relatively good performance in 2008, relegating SAFE to a supporting role when it came to higher return-seeking strategies on foreign reserves. SAFE was heavily criticised by the Chinese authorities, given its relative underperformance to CIC.

2009-2014: Strategic diversification

With the 2009 appointment of financial bureaucrat Yi Gang as chief executive officer and the 2010 poaching of Zhu Changhong from PIMCO, the world's largest bond fund manager, to become SAFE's chief investment officer, a more strategic form of diversification was back on the agenda.

In fixed income, SAFE resumed a more conventional central bank asset allocation with the majority of its debt holdings still in US Treasuries, although Zhu Changhong helped diversify this portfolio, increasing exposure to US corporate bonds. Government agency debt holdings reduced substantially.

In equities, although most of its exposure was withdrawn, Yi Gang and Zhu Changhong favoured a continued investment in large cap equities as a currency hedge. Most of SAFE's equity investments are handled through the subsidiaries in London and Hong Kong. There is little transparency regarding SAFE's equity investments. Most are held in major OECD economies including Germany, Japan, Australia and other parts of Europe. Changhong has been behind the large increase in Japanese exposure since 2010.

In 2011, SAFE became more active investing in alternatives after its earlier unsuccessful foray into private equity in 2008. Although it maintained its initial private equity holdings in TGP, it started mandating new PE managers in 2011. In 2012, it focused more on illiquid assets to increase returns, allocating to UK real estate and infrastructure through its London office. In real estate, while SAFE has focused on London property, it has also targeted some provincial European cities and student accommodation. It typically co-invests in real estate assets but also uses real estate funds, committing $500 million to Blackstone's Real Estate Partners VII in July 2012, the largest investment fund ever raised closing at $13.3 billion.

In infrastructure, investment was spurred by the British government's active recruitment during 2012 of Chinese capital to UK projects. In July of that year, SAFE acquired a 10% stake in Veolia Water Company, the second largest provider of water in the UK, co-investing with two Partners.

In a further diversification move in 2013, SAFE Co-Financing was created to provide loans to Chinese companies investing abroad. This entity's creation is part of an effort to build a market-oriented framework for SAFE's reserve management. There is no public record of how much capital it has been allocated, but its establishment signals potential for greater direct investment activity by SAFE.

Following Zhu Changhong's departure as Chief Investment Officer in January 2014, a replacement is yet to be appointed and so the likely direction of SAFE's investment strategy remains to be seen. These gradual diversification moves aside, the vast` majority of the portfolio remains invested as foreign exchange reserves, with a portion invested in global large-cap equities through an index replication strategy, as a hedge against currency fluctuations.

CIC

CIC's investment history is short, with the 2008 global financial crisis making it a more conservative investor than peer funds. Today, it is a globally diversified investor with a long-term investment horizon. Its investment approach is underpinned by four investment principles:

01. CIC investments are long-term, sustainable and risk-adjusted;

02. CIC is a financial investor and does not aim to gain control of enterprises or sectors through its investments;

03. CIC's investment decisions are research driven and based on commercial rates of return;

04. CIC is socially responsible. It abides by the laws and regulations of countries that host its investments and avoids investing in socially undesirable industries, such as tobacco and gaming.

These principles were developed in response to international concerns regarding potential political influences on CIC's investments. They were designed to reassure potential recipient countries, in particular the US, that CIC investments pose no threat to their national security.

As CIC's investment life commenced during the height of the global financial crisis, its initial investment strategy focused on opportunistic investments in the finance sector. By the end of 2008 it had made two major investments: $3 billion in the Blackstone Group and $5.6 billion in Morgan Stanley. CIC incurred a huge paper loss on these investments due to the financial crisis, but the loss did not prevent CIC from appointing Blackstone and Morgan Stanley in July 2009 to oversee its hedge fund investments, starting with an initial $500 million allocation to Blackstone. CIC reportedly also invested $800 million in a Morgan Stanley global real estate fund in the first quarter of 2009.

While CIC is expected to play its part in enhancing China's resource security and seeks investment opportunities in this sector, the fund does not have to invest directly to help secure China's supply of key natural resources. SOEs are more likely to be at the forefront of strategic foreign investments, with discreet CIC support through the state-owned banks. That said, between 2009 and 2011, CIC's main focus was commodities. The fund took direct stakes in the energy sector with headline investments in global resources companies. In 2009, CIC invested $300 million in a 45% share of a Russian oil company Nobel, and $939 million for a stake in a Kazakhstan oil and gas company, JSC KazMunai. Such investments not only provide a hedge against domestic inflation, they also offer a proxy exposure to China's economic growth and the wider demand within emerging markets for energy, food and consumer goods.

As CIC cannot rely on a steady income stream, it aims to become self-financing. Accordingly, developed market infrastructure that can yield a long-term income stream has become a priority. Other long-term investments take the form of allocations to private equity with small tickets sizes. Today, CIC's investment approach mimics that of a university endowment model, like that of the Harvard Management Corporation and Yale Investment Office. This has also influenced its majority outsourcing of asset mandates, following Harvard's approach in this area.

External mandates

When it first started investing, CIC attempted to build internal capabilities to reduce fees. But high staff turnover has hindered this strategy. Today, CIC outsources the majority of its assets to external mandates. As at December 2013, 32.8% of the portfolio was internally managed (down from 36.2% in December 2012), with the other 67.2% outsourced. This reflects the fund's commitment to seek alpha returns. While CIC maintains a large proportion of index and enhanced-index investment in public markets to capture beta/benchmark returns, it is also trying to improve its alpha return-generating capability in-house. It has set up a dealing room to this end.

Hong Kong: HKMA Investment Portfolio

► Key features

- The Hong Kong Monetary Authority (HKMA) is Hong Kong's central banking institution, managing the Exchange Fund, one of the largest official reserves in the world. The Monetary Authority's core function is to maintain monetary and banking stability;
- The Exchange Fund was set up to protect the value of Hong Kong's currency. The Hong Kong dollar is part of a linked exchange rate system, in place since 1983, where its exchange value is tied to the US dollar at an internally fixed rate of HK$7.80 to 1US$;
- The Exchange Fund holds the official reserves of Hong Kong predominantly in foreign currency assets including cash, short-term deposits, foreign government bonds, equities and gold. It is divided into three sections: the backing portfolio, investment portfolio (since 1998) and strategic portfolio (since 2007);
- The investment portfolio holds excess reserves and is tasked with seeking higher returns through more aggressive risk-taking than the backing portfolio, which may only hold US$ denominated securities and pursue traditional reserve management strategies;
- Other sovereign investment entities with similar investment portfolios for excess reserves include SAMA and SAFE, both of whom diversify a portion of excess reserves into higher return-seeking portfolios under their central banks management;
- Although Hong Kong does not have a sovereign wealth fund, the investment portfolio is often considered akin to a sovereign wealth fund.

Fund snapshot

Year Established	
Exchange Fund	1935
Investment Portfolio	1998
Assets Under Management	
Exchange Fund	US$311 billion[1]
Investment Portfolio	US$65.1 billion
Source of Funds	
Exchange Fund	Foreign exchange reserves
Investment Portfolio	Excess foreign exchange reserves

1. Total reserves for 2013 with gold at market price (end Dec 2013), IMF IFS Data of 19 March 2014.

I. Overview: Economic and political context

The HKMA's role as a de facto central bank – de facto in that the Monetary Authority does not actually issue currency itself but authorises certain institutions to do so – is a product of the special administrative region's currency history. For most of its past, as a trading and financial centre, Hong Kong has had a form of linked exchange rate. Today, within Asia, Hong Kong is an advanced economy, alongside Singapore and Korea. It has a highly open economy with a large financial sector, making it vulnerable to external financial shocks and volatility. This has made the preservation of currency stability, through the linked exchange rate, a high priority.

1841-1935: Emergence of a Hong Kong currency

When Hong Kong was established as a free-trading port in 1841 under British rule, there was no local currency in circulation – but a mixture of foreign currencies was in use. After several unsuccessful attempts to introduce sterling silver coinage, in keeping with the official policy of converting all colonies to British sterling, the Hong Kong government declared the silver dollar – then a kind of international currency – to be the legal tender for Hong Kong in 1863, and in 1866 began issuing a Hong Kong version. The silver standard became the basis of Hong Kong's monetary system until 1935, when, during a world silver crisis, the government announced that the Hong Kong dollar would be taken off the silver standard and linked to the pound sterling at a rate of HK$16 to the pound.

1935-1976: Birth of the Hong Kong dollar (HKD) and the Exchange Fund

By 1935, Hong Kong and China, the only two remaining adherents to the silver standard, abandoned silver and introduced a crawling peg to sterling of 1 pound = 15.36 to 16.45 dollars. With this move, the Hong Kong dollar as a distinct currency was born. That same year, a law known as the Currency Ordinance (later renamed the Exchange Fund Ordinance in 1948) established what is today's Exchange Fund, as a reserve to back the issue of Hong Kong's banknotes. The Exchange Fund was originally held in gold, silver and British pounds.

This original backing role of the Exchange Fund was expanded in 1976 to include the management of the official reserves when the assets of the Coinage Security Fund (which held the backing for coins issued by the government) and the bulk of foreign currency assets held in the government's General Revenue Account were transferred to the Exchange Fund. This arrangement was introduced to avoid fiscal reserves having to bear exchange risks arising from investments in foreign currency assets and to centralise the management of the government's financial assets. From then on, all resources available to regulate the exchange value of the Hong Kong dollar were centralised in the Exchange Fund. The Exchange Fund may be held in Hong Kong currency, foreign exchange, gold or silver, or in such securities or assets as the Financial Secretary considers appropriate after having consulted the Exchange Fund Advisory Committee. The HKMA is appointed by the financial secretary to manage the Exchange Fund, among other duties.

1983: Adoption of a linked exchange rate system for the HKD

Not long into the life of the expanded Exchange Fund, Hong Kong experienced the 'Black Saturday' crisis in 1983. This prompted the introduction of a linked exchange rate system, a type of exchange rate regime where the exchange rate of a currency is linked to another – in Hong Kong's case, the HKD was pegged to the USD at an internal fixed rate of HKD 7.80 to USD 1. This stabilising mechanism differs from a fixed exchange rate, where a government or central bank can intervene in the foreign exchange market by controlling supply and demand of the currency to influence the exchange rate.

Hong Kong is one of very few economies to adopt a linked exchange rate system, but the government considers the mechanism essential given the openness and external orientation of Hong Kong's economy, with external trade in goods and services equivalent to around three times GDP. This has made the preservation of a stable exchange rate a high priority.

1993: Establishment of the Hong Kong Monetary Authority (HKMA)

In 1993, the HKMA was established to improve Hong Kong's banking regulation and oversight. The Authority assumed responsibility for the Exchange Fund as well as ensuring the broader stability and integrity of the monetary and financial systems of Hong Kong.

As part of protecting the exchange value of Hong Kong's currency, the HKMA assumed oversight of the linked exchange system. To this end, the HKMA authorises note-issuing banks to distribute new banknotes provided they deposit the equivalent value of US dollars with the HKMA. The HKMA guarantees to exchange USD into HKD, or vice versa, at the rate of 7.80. When the market rate is below 7.80, the banks will convert USD for HKD from the HKMA, HKD supply will increase, and the market rate will climb back to 7.80. The same mechanism also works when the market rate is above 7.80, and the banks will convert HKD for USD.

In May 2005, the HKMA set 7.85 as an upper limit and 7.75 as a lower limit for the HKD to flow between. The HKMA will sell or buy HKD in the market when the exchange rate is at (or extremely close) the lower limit and upper limit respectively.

1997-1998: Handover of Hong Kong and establishment of investment Portfolio and Exchange Fund Investment Limited (EFIL)

Upon the establishment of the Special Administrative Region (SAR) on 1 July 1997, the assets of a Land Fund Trust amounting to about HK$211.4 billion were vested in the Hong Kong SAR government. At the financial secretary's instruction, these were placed with the Exchange Fund but managed as a separate portfolio between 1 July 1997 and 31 October 1998.

From 1 November 1998, the assets of the Land Fund were merged into the Exchange Fund and effectively became part of the newly established investment portfolio. Prior to this, the Exchange Fund had consisted entirely of a backing portfolio, dedicated to protecting the exchange value of Hong Kong's currency through the accumulation of US dollar assets. In contrast, the investment portfolio was established to pursue longer-term investments to preserve the value of the fund for the future benefit of the Hong Kong citizenry. Its assets were to be allocated to bond and equity markets of OECD member countries to preserve long-term purchasing power. This portfolio arrangement enabled a higher investment return on excess assets, while meeting liquidity needs through the backing portfolio. Despite this portfolio segregation, under the linked exchange rate system, all Exchange Fund assets are available to support the Hong Kong dollar exchange rate.

In addition to the investment portfolio, another portfolio was set up to hold the substantial amount of Hong Kong equities accumulated as a result of the government's operations in the stock market in August 1998. EFIL was established on 14 October 1998 to manage the Hong Kong equity portfolio purchased in August together with the Hong Kong equities transferred from the Land Fund. EFIL has been charged with the responsibility of recommending and executing a disposal programme under which the bulk of these Hong Kong equities will be returned to private sector hands in an orderly manner without disrupting the market.

With the adoption of the new investment benchmark of the Exchange Fund, which includes a 5% allocation to the Hong Kong equity market, HKMA has also asked EFIL to manage, through external managers, the Hong Kong equities to be held as a long-term investment portfolio.

2007: Long-term growth portfolio

In 2007, the long-term growth portfolio (LTGP) was established to hold a small tranche of assets in private equity and real estate. It effectively forms the higher-return, long-horizon component of the Exchange Fund along with the investment portfolio. A strategic portfolio was also established at this time to hold shares in Hong Kong Exchanges and Clearing Limited acquired by the government for strategic purposes. Because the strategic portfolio is not included in the assessment of the Exchange Fund's investment performance fund, it will not be discussed further here.

2008-2013: Increasing diversification and stable leadership

Following inflationary pressures and volatility resulting from the financial crisis, the Exchange Fund holdings in the investment portfolio and LTGP were diversified. Over the past five years, the Authority has moved into emerging market sovereign bonds and equities, overseas property, mainland renminbi assets and private equity. On 21 March 2014, the chief executive of the HKMA, Norman Chan, had his appointment renewed for a second five-year term. Chan first became chief executive in 2009, after a career at the HKMA and stints at Standard Chartered Bank and the Hong Kong government.

II. Official mandate(s)

The fundamental mission of the Exchange Fund, as set out in its founding law in 1935, is to safeguard the exchange value of the Hong Kong dollar. In 1976, the role of the fund was expanded to include the management of official reserves.

This mission was further extended in 1992 to include a subsidiary role of maintaining the stability and integrity of Hong Kong's monetary and financial systems, with a view to promoting Hong Kong as an international financial centre. Accordingly, the current institutional mandate of the HKMA is to:

– Maintain the stability of the Hong Kong dollar;

– Manage Hong Kong's official reserves through the Exchange Fund;

– Promote the stability and integrity of Hong Kong's banking system;

– Maintain and develop Hong Kong's financial infrastructure.

The Exchange Fund's investment mandate is to:

01. Preserve capital;

02. Ensure that the entire monetary base will be at all times fully backed by highly liquid short-term US dollar denominated securities;

03. Ensure sufficient liquidity for the purpose of maintaining monetary and financial stability;

04. Achieve an investment return that will preserve the long-term purchasing power of the assets.

To achieve these investment objectives, the assets of the Exchange Fund are managed in three separate portfolios (there is a third portfolio treated separately and discussed below):

– A backing portfolio holding short-term, highly liquid US dollar-denominated securities to fully back the monetary base (objectives 2 and 3);

– An investment portfolio and LTGP engaging in longer-term investments to preserve the value of the fund for the future benefit of the people of Hong Kong (objectives 1 and 4).

III. Source of funding

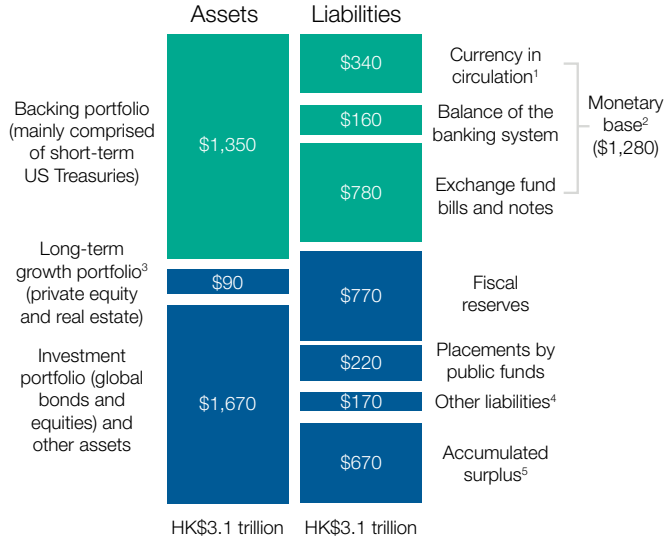
The source of funding for the Exchange Fund is three-fold. It consists of:

01. Official reserves;

02. Fiscal and other public fund reserves;

03. Reinvested accumulated surplus of the Exchange Fund.

Table 1: Breakdown of HKMA Exchange Fund Assets



Source: Chan, N. (2014). The Exchange Fund – Last Line of Defence for Financial Stability, 28 July 2014

1. Including certificate of indebtedness and government issued currency notes and coins in circulation.
2. Montary base calculated based on prevailing accounting principles.
3. Aggregate market value of investments, excluding outstanding undrawn investment commitments (around $80 billion) and net of bank loans.
4. Other liabilities, include mortgage-backed securities issued, other debt securities issued, unsettled purchases of securities, accrued charges and other liabilities, interest payable, tax payable and deferred tax liabilities.
5. Including revaluation and translation reserves (around $10 billion).

Table 1 shows the breakdown of Exchange Fund assets, showing the fund's distinct funding sources and how they are allocated to different internal portfolios within the Exchange Fund.

Each funding source has a different rule governing its transfer to and from its host portfolio within the Exchange Fund:

Transfer rule for the backing portfolio (official reserves): The backing portfolio holds the assets that constitute the monetary base of Hong Kong. All assets required to maintain that base are, therefore, transferred into the backing portfolio, which accounts for about 30% of Exchange Fund assets. It is comprised entirely of US dollar-denominated securities on account of its need to be highly liquid.

Transfer rule(s) for the investment portfolio: The investment portfolio holds excess reserves, both official and fiscal. The original seeding of the investment portfolio at its 1998 establishment came from Land Trust handover to the Hong Kong government, amounting to HK$211.4. Since 2000, the investment portfolio has received funding from official reserves according to a transfer rule approved by the financial secretary:

– When the backing ratio reaches 112.5% (the upper trigger point), assets will be transferred out of the backing portfolio to the investment portfolio to reduce the ratio to 110%;

– Conversely, should the ratio drop to 105% (the lower trigger point), assets will be injected from the investment portfolio to restore it to 107.5%.

As is evident in Table 1, the HK$1.35 trillion in the backing portfolio exceeds 100% of the value of the monetary base (HK$1.28 trillion). This arrangement allows the Exchange Fund to pursue higher investment returns on excess assets, while ensuring there are sufficient liquid assets in the backing portfolio.

The investment portfolio also receives funding from two other sources: fiscal reserves and the surplus holdings of other public funds. Since 1976, the government of Hong Kong has placed the bulk of its fiscal surpluses from the government's General Revenue Account with the Exchange Fund in return for interest income. This transfer seems to take place according to a broad consensus that all fiscal surpluses should be placed in HKMA's hands. This arrangement was introduced to avoid fiscal reserves having to bear exchange risks as part of the Linked Exchange Rate, allow surpluses to be invested prudently and bolster the Exchange Fund's assets to allow it to perform its statutory functions more effectively. Other public agencies, including the Research Endowment Fund, the Community Care Fund and the Samaritan Fund have transferred some HK$220 billion of not immediately needed funds.

Transfer rule for the LTGP: The LTGP does not have explicit funding rules, but rather a maximum allocation. Its assets are capped at one-third of the accumulated surplus of the Exchange Fund – the part of the fund that is effectively liability free, since it constitutes the fund's own capital. The accumulated surplus of the fund represents the Exchange Fund's investment gains gradually built up over the years, which stood at HK$660 billion at the end of 2013. As evident in Table 1, the HKMA has not hit the one-third cap of approximately HK$220 billion, having committed around HK$170 billion to this portfolio. The LTGP can hold fewer high-liquidity, higher risk assets that promise better yields over the long-term, as it is financed by the Exchange Fund's own capital. To this end, it invests in private equity and real estate assets.

IV. Liabilities

On the liabilities side, the Exchange Fund has three main obligations:

01. Monetary base;

02. Government deficit/public finance needs;

03. Exchange rate.

Monetary base met by the backing portfolio: The backing portfolio must be constantly liquid to meet any shortfalls in the financial system. It also has specific short-term liabilities insofar as a substantial portion of this portfolio – HK$780 billion – flowed into Hong Kong following the collapse of Lehman Brothers in 2008.

Government deficit/public finance needs met by the investment portfolio: The investment portfolio also has no explicit liabilities insofar as its establishment was not linked to any particular public spending need. However, it is subject to periodic withdrawals, according to the transfer rule, to ensure the backing ratio between the monetary base and the assets in the backing portfolio is maintained. The rule holds that if the backing ratio drops to 105%, assets will be injected from the investment portfolio to restore it to 107.5%.

This portfolio is also subject to withdrawals by the government in times of deficit, since the fiscal reserves transferred to the Exchange Fund are not permanently appropriated for the use of the fund, but are repaid to the General Revenue Account when they are required to meet the obligations of the general revenue. As at end 2013, the government had HK$770 billion in fiscal surpluses stockpiled in the Exchange Fund. For this reason, part of the Exchange Fund is held in Hong Kong dollar-denominated securities, so as to meet the operational needs of the government. The Exchange Fund also provides guaranteed returns for the fiscal reserves, which means that under no circumstances would the fiscal reserves receive negative interest income or return.

The same applies to the excess funds entrusted to the Exchange Fund by other public agencies, totalling up to HK$220 billion. These assets could be drawn down by the government or depositing agencies at any time, and especially during budget deficits, as they were during four fiscal years between 2000 and 2004.

Since 1 April 2007, the Hong Kong Treasury collects a fee on the fiscal reserves placed with the Exchange Fund based on a fixed rate for the year determined every January. The rate is the average investment return of the investment portfolio for the past six years or the average annual yield of three year Exchange Fund notes for the previous year, whichever is higher.

Exchange rate: all of the Exchange Fund's assets are ultimately available to support the Hong dollar exchange rate. Moreover, the fund may be used to undertake intervention and open market operations to maintain monetary stability. This could result in drawdowns on both the backing and investment portfolios.

V. Governance structure

External governance

i. Savings and spending rules

The savings and spending rules for the Exchange Fund and its constituent portfolios are relatively technical. All foreign currency reserves are placed within the Exchange Fund. Assets are then either transferred to the backing portfolio or the investment portfolio.

As outlined above, the transfer rule to the backing portfolio holds that the amount of assets in this portfolio must equate to a backing ratio of 107.5% to 110% of the monetary base. The investment portfolio receives excess reserves. When the backing portfolio ratio reaches 112.5%, assets will be transferred to the investment portfolio to reduce the ratio to 110%. They will be transferred back to the backing portfolio if the ratio has dropped to 105%. In 2012, the financial secretary decided that the cap for the LTGP should be one third of the accumulated surplus of the Exchange Fund.

The spending of the HKMA assets is not rule-governed. The funds can be spent according to the needs of the government since the fiscal reserves transferred to the Exchange Fund are repaid to the general revenue account when they are required to meet the obligations of the general revenue. There is no SWF in Hong Kong, although the investment portfolio and LTGP of the Exchange Fund operate as such.

ii. Placement and reporting lines within the public sector

The HKMA is the de facto central bank of Hong Kong and is under the direct control of the financial secretary, who delegates management of the Exchange Fund to the HKMA.

The HKMA is closely connected to other key financial regulatory institutions within Hong Kong. It sits on both the Council of Financial Regulators (CFR), which focuses on cross-sector regulatory matters and is chaired by the financial secretary; and the Financial Stability Committee (FSC), responsible for monitoring the functioning of the financial system and any developments with cross-sector and systemic implications, chaired by the secretary for financial services and the treasury. These Committees were established under a framework to strengthen cooperation and coordination within the public finance sector.

iii. Transparency and disclosure

The HKMA is a relatively transparent and accountable institution. Through the financial secretary, it maintains democratic accountability to the people of Hong Kong. The chief executive of HKMA is required to appear three times a year before the panel on financial affairs of the legislative council, Hong Kong's supreme governing body, to brief members and to answer questions on the HKMA's work and the Exchange Fund. Representatives from the HKMA also attend legislative council panel meetings to explain and discuss particular issues.

The Monetary Authority also undertakes substantial public disclosure of its operations, policies and performance, ensuring direct accountability to the citizens of Hong Kong, financial industry and international community. To this end, it releases many of its key documents in both English and Chinese. It maintains comprehensive relations with the mass media, hosting presentations, producing special publications, research and fact sheets along with the usual annual reports and other statistical reporting that such institutions typically disclose.

This high degree of transparency is a result of gradual improvement in the level and frequency of its information disclosure. Prior to 1992, the accounts of the Exchange Fund were confidential. From 1992, the government started publishing the annual accounts of the fund and, since June 1995, bi-annual accounts have been published. Headline figures for the foreign exchange reserves have been released monthly since January 1997.

From 1999, the financial secretary decided to publish, on a monthly basis, an abridged balance sheet of the Exchange Fund and a set of currency Board accounts. The HKMA has also participated in the IMF's Special Data Dissemination Standard (SDDS) project for central banks. Under this, the HKMA publishes records of meetings of the currency Board sub-Committee of the Exchange Fund advisory Committee and the reports on currency Board operations. The supervisory policies and guidelines on banking have been published on the website since 1996. In 2000, SDDS was further strengthened by the implementation of a data template on international reserves and foreign currency liquidity. The template, which is completed and released before the end of each month, provides a comprehensive account of the IMF participant's foreign currency assets, and depletion of resources, arising from liabilities and commitments.

Internal governance

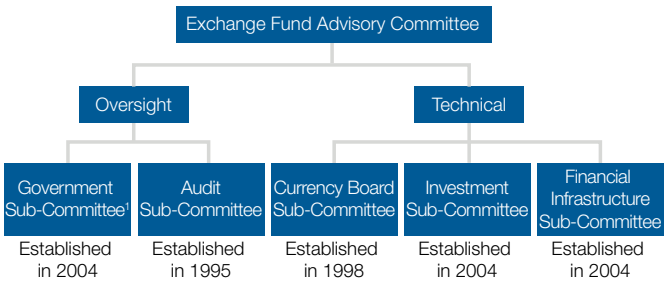
iv. Institutional governance

The Exchange Fund is under the ultimate control of the financial secretary of the Hong Kong government. A number of advisory Committees provide guidance on the HKMA's work. The most important of these is the Exchange Fund Advisory Committee (EFAC), which, together with its sub-Committees (see Figure 1), carries out many of the functions of a Board.

The EFAC is a 15-member Committee, chaired by the financial secretary as ex officio Chairman. Committee members are appointed in a personal capacity by the financial secretary and not as representatives of any other organisation or body. Members of EFAC are appointed for their expertise and experience, including knowledge of monetary, financial and economic affairs and of investment issues, as well as of accounting, management, business and legal matters.

EFAC advises the financial secretary on investment policies and strategies for the fund and on projects such as the development of financial infrastructure. Since the operating and staff costs of the HKMA are also chargeable to the Exchange Fund, EFAC advises the financial secretary on the HKMA's annual administration budget and on the terms and conditions of HKMA staff. EFAC meets regularly and on occasions when particular advice is being sought.

Figure 1: Exchange Fund sub-Committee structure



Source: HKMA Governance Backgrounder (p91)

1. Formerly the Remuneration and Finance Sub-Committee (established in 2001), which was formerly the Working Group on Terms and Conditions of Service (established in 1993).

Sub-Committees

EFAC is assisted in its work by five sub-Committees, which monitor and advise on specific areas of the HKMA's work and make recommendations to the financial secretary through EFAC. As set out in Figure 1, three of these sub-Committees are technical in nature: the currency Board sub-Committee, the investment sub-Committee, and the financial infrastructure sub-Committee. The remaining two – the governance sub-Committee and the audit sub-Committee – carry out oversight of the HKMA's work.

v. Investment and risk management process

Investment issues of the Exchange Fund are primarily the responsibility of the EFAC and its investment sub-Committee, which advise the financial secretary on investment policies and strategies for the Exchange Fund. This advice primarily concerns the overall investment strategy of the fund, including the strategic asset allocation which is formed in light of the investment benchmark and the long-term optimal allocation of the fund.

The investment sub-Committee monitors the HKMA's investment management work and makes recommendations on the Exchange Fund's investment policy and strategy, risk management and other related matters, including:

01. The investment benchmark for the Exchange Fund;

02. The investment policy and risk management of the fund;

03. The investment strategy for the fund;

04. Any other matters referred to the sub-Committee in connection with the investment management of the Exchange Fund.

The investment sub-Committee members are also appointed in a personal capacity. Meetings are confidential and it is not disclosed how regularly the Committee meets or the procedures for making recommendations.

When it comes to managing this investment strategy, internal and external managers are guided by the strategic allocation, but also allocate assets tactically, in an attempt to achieve a return above that of the benchmark. While the benchmark and the limits for tactical deviations are determined by the financial secretary, in consultation with EFAC, tactical decisions are made by the HKMA under delegated authority. Within the limits allowed for tactical deviations, portfolio managers may take positions to take advantage of short-term market movements.

At the beginning of 1999, the Exchange Fund adopted a new long-term asset allocation strategy, commonly known as an 'investment benchmark', which includes 80% allocation to bonds and 20% allocation to equities. In terms of currencies, the investment benchmark includes 80% in the US dollar bloc, 15% in the euro bloc and 5% in the yen bloc.

VI. Investment style and strategy

Since its establishment, the HKMA has adopted an active management approach and is one of the few central banks to invest in equities. Within this broad active investment philosophy, the investment strategy of the fund differs for its distinct portfolios.

The backing portfolio strategy is conservative, short-term and non-diversified with holdings restricted to highly liquid, top quality, short-term US papers – given the portfolio's primary purpose of backing the monetary base of Hong Kong.

The investment portfolio's strategy involves greater diversification, higher risk-taking and a longer-term outlook. At inception, in 1998, it was relatively undiversified, holding only developed market equity and bonds in OECD economies. However, in the past five years, its holdings have been expanded into higher risk-return assets following inflationary pressure in 2008 and 2009 and volatility caused by the financial crisis in developed economy bond and equity markets. HKMA began accumulating emerging market sovereign bonds in 2008; private equity in 2009; overseas real estate in 2010 and now emerging market stocks through external asset managers.

In 2012, the EFAC advised the financial secretary to re-group the private equity and real estate assets in the LTGP while keeping the emerging market bonds, equities and renminbi assets in the investment portfolio to allow for further expansion of the long-term portfolio.

While this signals a commitment to on-going diversification, the HKMA remains a broadly conservative investor. The long-term target, bond-to-equity mix, for both portfolios together is 75:25, underscoring an overriding preference for traditional fixed income assets. Much of this is explained by the fundamental mandate of the Exchange Fund to back the monetary base, and is also reflected in the currency mix of the fund's assets with 79% in US dollars and 21% in other currencies including Australian dollars, Canadian dollars, Sterling, Yen and Euro.

Direct investor with limited external mandates

As at the end of 2012, about 80% of the Exchange Fund's assets were managed internally, including the entire backing portfolio and part of the investment portfolio. The part of the investment portfolio directly managed is a multi-currency portfolio invested in the major fixed-income markets. The 20% of Exchange Fund's assets outsourced to external mandates includes all of the fund's listed equity portfolios and other specialised assets. The HKMA's external managers are based in over a dozen international financial centres.

Kazakhstan: National Fund of Kazakhstan

▶ Key features

- The National Fund was established in 2000 with the dual purpose of stabilisation and savings;
- The fund receives deposits of oil and gas revenues, as well as the proceeds from the privatisation of state property from the mining, manufacturing and agricultural sectors;
- The fund has a detailed withdrawal rule, but the rule has changed three times in seven years;
- The National Bank of Kazakhstan serves as operational manager for the fund, but all major strategic and policy decisions regarding the fund are made by the powerful management council, consisting of the president, prime minister and high-ranking ministers, government officials and parliamentarians;
- While deposit and withdrawal amounts are made public, there is virtually no public reporting on specific assets or even asset allocation;
- The transfer of funds in and out of the National Fund is governed by presidential decrees, the most recent (and current) of which empower parliament to authorise annual deposits and withdrawals from the National Fund.

Fund snapshot

Year Established	2000
Assets Under Management (as at Oct 2014)	$71.1 billion
Source of Funds	Oil-related fiscal revenues, plus privatisation proceeds
Portfolio at a glance (savings portfolio)	Details undisclosed, but portfolio concentrated in US Treasuries,, non-US sovereign bonds (rated AA or Aa2 or higher by Standard & Poor's and Moody's), debt securities of international financiall institutions, deposits and highly rated corporate debt
Portfolio at a glance (stabilisation portfolio)	Details undisclosed, but global fixed income 70%-100% and globall equities 0%-30%

I. Overview

The origins of the National Fund of Kazakhstan lies in the sharp increase in the country's oil and gas production in the late 1990s, following the development of the Caspian Pipeline from the Tengiz field to the Black Sea. The pipeline facilitated a sharp increase in oil and gas production, exports and revenues. Following a downturn in the Kazakh economy, in the aftermath of the 1998 Russian debt crisis, the decision was taken in 2000 to establish an SWF.

Thus, in August 2000, the National Fund of Kazakhstan was created through a decree issued by the president. The fund was intended to serve as a stabilisation function, reducing the negative impact of volatile oil and gas prices and production; and as a savings function, preserving a portion of oil and gas revenues for future generations.

The most striking feature of the National Fund's governance structure is the high degree of direct control over the fund that is held by the president and senior ministers. Unlike many peer resource funds, such as those in Norway, Abu Dhabi, Chile and Botswana, the Kazakh leadership has not delegated significant powers for determining the fund's strategy and major policy decisions to an independent or technocratic body. The National Bank of Kazakhstan merely serves as an operational investment manager, implementing the strategies and policies of the powerful Management Committee.

While the National Fund is, therefore, very much at the mercy of the political discretion of the president and senior ministers, sharp increases in oil and gas production and supportive prices since the fund's inception in 2000 have resulted in the steady accumulation of assets held and managed by the National Fund. Since inception, the National Fund has invested exclusively in foreign assets, while Samruk-Kazyna, Kazakhstan's domestically-orientated SWF, has pursued a mandate of state-led industrial development, privatisation and restructuring of state enterprises, and the diversification of the domestic economy.

II. Official mandate(s)

The institutional mandate of the National Fund of Kazakhstan is to serve both a stabilisation and savings function. To this end, the fund has two distinct portfolios:

01. A stabilisation portfolio, invested in highly liquid assets with low credit risk;

02. A savings portfolio, investing in longer-dated bonds and equities.

Since inception, the National Fund has been mandated to invest only in foreign assets, as domestic public investment has been conducted through standard fiscal channels, as well as a plethora of public and quasi-public enterprises. The most notable of these is Samruk-Kazyna, a state-owned domestic holding company that holds stakes in the leading Kazakh corporations and enterprises (including rail and postal services, the national airline, oil and gas producers and numerous financial companies).

With around $80 billion in assets under management – which equates to roughly 60% of the Kazakhstan economy – Samruk-Kazyna is comparable in size to the National Fund, and is a major tool for domestic economic development, diversification and industrial policy. Samruk-Kazyna is an instrument of industrial policy and diversification, and its mandate is more directly developmental than that of the National Fund. One of Samruk-Kazyna's most important stated functions is to modernise, restructure and streamline state-owned enterprises, with a view to privatising (or partially privatising) these entities and attracting private capital.

The National Fund's mandate is, therefore, more in line with the SWFs of Norway, Chile and Abu Dhabi, who pursue their stabilisation and savings objectives through investments in offshore assets. However, with the rapid rise in assets under management of the National Fund in recent years (which is expected to continue over the coming decade), the minister of economic affairs has recently suggested that the National Fund will also be charged with making domestic investments.

III. Source of funding

The funding source for the National Fund underwent a significant change in 2005, when the Kazakh authorities moved to clarify the type of revenues that are to be transferred to the fund. It is, therefore, useful to contrast the savings rule that governed the fund from 2000 to 2004 and that which has applied since 2005.

The 2000 to 2004 rule was rather ambiguous: the budget surplus, determined annually by the president, was deposited from the national budget into the National Fund. This savings rule imposed very little constraint or discipline on the leadership and finance ministry of Kazakhstan, as they were under no obligation to run a fiscal surplus, even during times of booming oil and gas prices and rapid rises in production levels.

In 2005, however, the president issued a decree that specified the sources of funding for the National Fund more clearly. The decree, which continues to pertain to the transfer of revenues to the National Fund, defined the fund's source of financing as follows:

- Direct taxes (excluding local taxes) on approved petroleum corporations, including corporate income tax, excess profit tax and rent tax on oil and gas exports as well as bonuses, royalties and production sharing;
- Other income from petroleum operations such as fines from violations of the terms of an oil contract;
- The proceeds from the privatisation of state property in the mining and manufacturing sectors;
- Proceeds from sales of agricultural land;
- Investment income generated by the Fund;
- Other income deposited by the government that is not prohibited by law.

While the post-2005 clarification of the source of funding is an improvement on the preceding framework, it still leaves significant scope for discretion and manipulation by the political leadership of Kazakhstan – and the transfer of revenues to the National Fund is, therefore, largely dependent on continued political will to save oil and gas revenues through the fund. For example, the minister of finance and the minister of oil and gas jointly approve the list of petroleum corporations that pay the aforementioned taxes, and the list changes from year to year.

IV. Liabilities

The National Fund has also been subject to important changes around how its liabilities or withdrawals process are defined. Since inception, the fund has undergone three important phases in its 'spending rule', with changes to the original rule in 2005 and then again in 2010. The prevailing spending rule in these three periods can be summarised as follows:

From 2000 to 2004 there was essentially no formal, or even semi-formal, spending or withdrawal rule. Withdrawals and transfers of funds out of the National Fund back to the government were unclear, and made at the discretion of the president.

In 2005, the president issued a decree according to which withdrawals from the National Fund were supposed to be earmarked for exclusive use in financing long-term development programmes, rather than current budget expenditures. The amount was determined using the following formula:

$S = C + rNF_{t-1} * FX$, where

S = the transfer amount;

C = a three-year estimate of the average cost of budgeted development programmes;

r = a three-year estimate of the National Fund's investment income;

NF_{t-1} = the value of National Fund assets at the beginning of the fiscal year;

FX = the exchange rate between the Kazakh Tenge and the US dollar.

While this formula-based spending rule, which also required legislative approval, was an improvement on the preceding procedures for withdrawals from the National Fund, significant scope for manipulation remained. For example, the classification of expenditure as development programmes, rather than current expenditure, estimates of the costs of such programmes and the anticipated investment income generated by the fund, were all means by which larger amounts could be withdrawn from the National Fund than was consistent with long-term savings and asset accumulation. Moreover, one-off withdrawals,

called ‘targeted transfers’, were permitted – and, indeed, authorised in 2008-2009 – in order to finance Samruk-Kazyna and KazMunaiGas, the national oil company, during the 2008 global financial crisis. Targeted transfers totalled approximately $7 billion. Against this, a rule was adopted in order to avoid depleting the National Fund, capping transfers at one-third of the fund’s capital.

In 2010, the spending rule was changed again, through another presidential decree under which transfers from the National Fund were anchored around a nominal amount of $8 billion per year. The transfer amount can be adjusted by 15% by parliament, depending on the state of the economy and can be used to fund current budget expenditure, in addition to development programmes. In 2012, for example, parliament passed a law authorising the transfer amount of $9 billion for 2013. The current earmarked transfers for 2014 and 2015 are reduced back to approximately $8 billion in each year. In addition, the decree states that the balance of the National Fund cannot fall below 20% of GDP in a given fiscal year – if it does, the shortfall has to be covered by cutting the fixed annual transfer by the amount needed to cover the difference. Finally, withdrawals to cover the National Fund’s operational expenses and annual external audits are permitted.

V. Governance structure

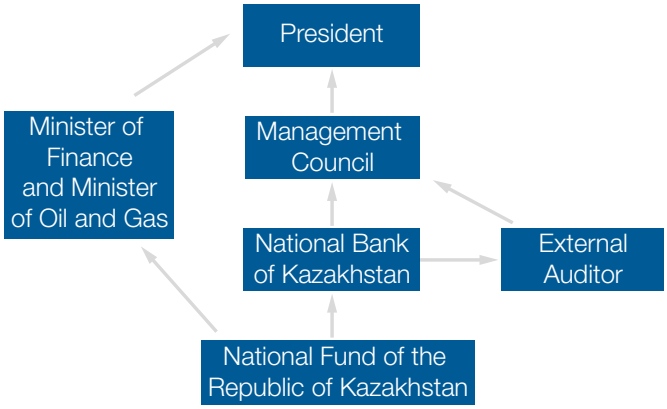
The National Fund of Kazakhstan is characterised by an exceptionally high degree of centralised authority and oversight, with the president serving as the highest reporting authority of the fund and as a member of the Management Committee. In recent years, steps have been taken to introduce a more rule-based framework for deposits and withdrawals from the fund, although the frequent changes to these rules, the remaining scope for the manipulation of the key variables in the rules, the possibility of withdrawals mainly, and the lack of independence of the Management Committee mean that the political leadership, particularly the president and senior ministers, still have a high degree of control and discretionary power over the fund. The National Fund also remains relatively non-transparent around key aspects of its operations and performance.

External governance

i. Savings and spending rules

The transfer of funds in and out of the National Fund is governed by presidential decrees, the most recent of which empower parliament to authorise annual deposits and withdrawals from the National Fund. These transfers are guided by clear principles, although the governing framework does allow significant drawdowns in times of economic hardship in Kazakhstan. The most recent framework for savings and spending around the National Fund is, however, a significant improvement on the fund’s initial institutional arrangements, which rested almost entirely on presidential discretion.

Figure 1: The inter-institutional reporting structure for the Kazakhstan National Fund



Source: National Fund of Kazakhstan

ii. Placement and reporting lines within the public sector

The National Fund is established as an independent institution. A particular feature of the institutional structure of the Kazakhstan fund is the formal recognition of the president as the highest reporting authority (something that is typically either strictly avoided, or only implicit, in other SWFs). Much of the authority for establishing the National Fund's policies and investment strategy rests with the management council, which, rather uniquely, includes the president alongside senior government officials. The National Bank of Kazakhstan, the country's central bank, serves as the fund's operational investment manager. The basic inter-institutional reporting structure for the National Fund is shown in Figure Two below, with key roles and responsibilities as follows:

- The President: officially recognised as the highest reporting authority of the National Fund. The president created the National Fund and the management council, on which he sits, through presidential decrees;
- The Management Council: consists of the president, key economic policy ministers and other high-ranking officials (including representatives of the legislature). The management council sets all key governance, operational and investment policies for the National Fund;
- The Minister of Finance and the Minister of Oil and Gas jointly approve the list of petroleum sector companies whose taxes are deposited into the National Fund, while parliament passes laws determining small variations in the amounts transferred from the fund annually;
- The day-to-day investment management of the National Fund is the responsibility of the National Bank of Kazakhstan. The central bank selects and oversees the fund's external managers of its equity portfolios;
- The central bank is subject to external audits, which includes its activities in relation to the investment of the National Fund's assets. These details of these audits are not made public.

iii. Transparency and disclosure

Transparency and disclosure around the National Fund remains very limited. The government and the central bank do make periodic disclosures around the size of the fund, withdrawal and deposit amounts, and provide very general information on its investment performance. However, details around its operational and strategic developments and decision-making processes are almost non-existent, and the fund does not produce detailed annual reports, websites or information of its actual investments. The Kazakh authorities have, however, participated in the formulation of the Santiago Principles and attended the regular meetings of the International Forum of Sovereign Wealth Funds and may, therefore, be expected to follow the general trends among member countries of the forum in increasing disclosure, transparency and accountability.

Internal governance

iv. Institutional governance

There is very little public information about the internal governance arrangements around the National Fund, apart from the fact that it its strategic management (including asset allocation, target return and risk tolerance) is determined by the management council, while operational investment is subsumed by the National Bank of Kazakhstan's foreign exchange reserves management process (with equity mandates outsourced to private-sector managers). The central bank does not release details around the organisation of this function and the deliberations of the management council are also not public information. The central bank is responsible for the selection and monitoring of external managers, subject to approval by the management council. The central bank reports to the managing council on the National Fund's investments, the performance of internal and external managers, and factors affecting the fund's investments and operations.

v. Investment and risk management process

The management council is responsible for all major strategic issues relating to the National Fund's investment strategy, including asset allocation, the definition of eligible assets, risk tolerance and investment horizon. The central bank's Board implements the investment strategies determined by the management council and oversees day-to-day management of the fund's two major portfolios.

VI. Investment style

The official investment objective of the National Fund is to invest the assets under its management in a way that preserves its value and maintains liquidity, while minimising risk to a moderate level. Since the fund has two main purposes, stabilisation and savings, its assets are also divided into two portfolios for investment purposes:

- The stabilisation portfolio is invested in highly liquid assets, similar to the central bank's foreign exchange reserves, so that funds can be mobilised as needed in the short-term to provide fiscal or other forms of macroeconomic stability;
- The savings portfolio is invested with a view towards generating long-term returns, although the portfolio remains a relatively conservative asset allocation of at least 70% exposure to fixed income securities, with the remainder invested in public equities. The list of approved asset classes and eligible instruments, includes:
  - Government and government agency debt securities;
  - Debt securities of international financial institutions;
  - Corporate debt;
  - Equities;
  - Deposits;
  - Derivatives;
  - Cash in foreign currencies;
  - Money market funds.

A detailed overview of the National Fund's asset allocation and actual investment is disclosed, and the target asset allocation of the Fund's two portfolios is only defined in very general terms, as follows:

- Stabilisation portfolio:
  - 50%-100% in typical reserve-currency deposits and short-dated US Treasuries;
  - 0%-50% in non-US debt securities, with a minimum credit rating of AA or Aa2 by Standard and Poor's and Moody's, and the debt securities of international financial institutions (IMF, BIS and World Bank);
  - 0%-50% in deposits;
  - 0%-20% in derivatives;
  - 0%-30% in corporate debt.
- Savings portfolio;
- 70%-100% in fixed income (sovereign, agency, corporate and international institutions);
- 0%-30% in public equity.

The National Fund is not currently permitted to invest in Kazakhstan. However, senior government officials have stated that this limitation could be lifted in the near future, as the National Fund's assets continue to grow on the back of rising oil and gas production and broadly supportive commodity prices.

Kuwait:
Kuwait Investment Authority

▶ Key features

– The Kuwait Investment Authority (KIA) is one of the world's longest standing sovereign investors, responsible for two major funds: the General Reserve Fund (GRF) with a domestic, developmental focus and the Future Generations Fund (FGF), an internally invested savings fund;

– The transfer of funds between the GRF and the budget is particularly obscure. The GRF is essentially an investment arm of the fiscal process, while the FGF is a more traditional savings fund with an international portfolio;

– The KIA, with estimated total assets under management of $332.5 billion between its two major funds, has a long track record of successful and prudent investment;

– The organisation and its funds are established in law, and there is strong (non-public) inter-institutional oversight and reporting, involving parliament, ministries, the central bank, independent Directors, auditors and senior internal management. Public disclosure around specifics of the KIA's portfolio is limited, and the exact size of the two funds is not public information;

– Its Board of Directors is appointed by the Council of Ministers and has ultimate responsibility over the organisation and its funds. The Board is chaired by the Minister of Finance and includes the minister of oil, the governor of the Central Bank of Kuwait, and the under-secretary of the Ministry of Finance, as well as five other Kuwaiti nationals from the private sector;

– In the wake of the 2008 global financial crisis and the subsequent decline in global oil prices, there has been considerable pressure on the KIA to reduce its foreign holdings in favour of domestic investments.

Fund snapshot

Year Established	1953
Assets Under Management (as at Oct 2014)	$548 billion
Source of Funds	Oil revenues

I. Background: Economic and political context

The history of the Kuwaiti oil sector dates back to the discovery of oil reserves in 1938 by the Kuwait Oil Company, when the territory was a British protectorate. Large-scale exploration was delayed until after World War Two and the use of Kuwaiti oil only began in 1951. By 1952, Kuwait had become one of the largest oil exporters in the Middle East with substantial oil-financed works.

Kuwait was an early adopter of the SWF model, creating the Kuwait Investment Board, based in London, in 1953, to invest the country's surplus oil revenues 'in order to provide a fund for the future and reduce Kuwait's reliance on its single finite resource'. In 1965, the Kuwait Investment Office (KIO) replaced the Kuwait Investment Board, with a total of 11 staff. In the early 1970s, the KIO's staff was increased to 24, the organisation took occupation of its current office at St Vedast House in the City of London, and started to diversify its assets and develop the foundations of its diversified portfolio.

In 1976, the Reserve Fund for Future Generations (today, the FGF) was established as a savings fund. In 1982, the organisation once again underwent a significant change with the establishment of the Kuwait Investment Authority (KIA). Since that time, the KIA has been charged with managing not only the general public assets and budget accounts, but, specifically, the FGF as an inter-generational savings fund and the GRF, as a domestic-orientation development fund.

The KIA is described as 'an independent public authority'. Its Board of Directors, appointed by the Council of Ministers, has ultimate responsibility over the organisation and its funds. By law, the Board is chaired by the minister of finance and includes the minister of oil, the governor of the Central Bank of Kuwait, and the under-secretary of the Ministry of Finance, as well as five other Kuwaiti nationals from the private sector. The Board appoints a Managing Director and an Executive Committee that assist the Board in setting the strategic goals and objectives of KIA, and is responsible for its day-to-day management. The KIA states that its 'long-established autonomy… helps assure that its investment decisions are based strictly on commercial, rather than geopolitical, considerations'. Public disclosure of the KIA's investments and funds are limited, but there is a high degree of inter-institutional oversight and reporting within the Kuwaiti public sector that is not made public.

II. Official mandate(s)

The institutional mandate of the KIA, according to its mission statements is: 'to achieve a long term investment return on the financial reserves… providing an alternative to oil reserves, which would enable Kuwait's future generations to face the uncertainties ahead with greater confidence'. The organisation has further articulated three primary institutional objectives, which can be summarised as follows:

01. Achieve a rate of return that exceeds its composite benchmarks, on a three-year rolling average, through:
    - An asset allocation consistent with its mandated return and risk objectives;
    - Selecting investments and investment managers with the ability to outperform the respective index for each asset class;
    - Making tactical changes to the asset allocation to benefit from economic and market trends.

02. Be a world-class investment management organisation, committed to continuous improvement, by:
    - Comparing its performance standards comparable to those of its peer group of large investment bodies, endowments or pension funds worldwide;
    - Continuous training and development of its staff;
    - Creating a dynamic organisational culture.

03. Commit to the excellence of the private sector in Kuwait while ensuring that it does not compete with, or substitute it, in any field. Towards this goal, KIA will:
    - Contribute to the formation of human capital in Kuwait by attracting talented and ambitious young Kuwaitis and training and preparing them to become the best investment professionals in the market;
    - Participate in the growth of the investment sector in Kuwait by doing business with the best performing companies and investing in their creative ideas;
    - Reinforce sound corporate governance, transparency in all operations, and fair business dealings in Kuwait by holding our business associates and portfolio companies to the highest ethical standards.

Since 1982, the KIA has been charged with managing (in addition to the general public assets and budget accounts of Kuwait), two separate sovereign funds, the FGF and the GRF. These funds have very different functions and objectives:

General Reserve Fund (GRF): This fund receives all of the State of Kuwait's oil revenues. It serves as a domestic development fund, holding stakes in Kuwaiti public enterprises, such as the Kuwait Fund for Arab Economic Development and Kuwait Petroleum Corporation, as well as Kuwait's participation in multilateral and international organisations (World Bank, International Monetary Fund, and the Arab Fund for Economic and Social Development).

Future Generations Fund (FGF): This fund receives 25% of all annual state revenues, including 10% of the net income of the GRF, and invests in foreign assets with the objective of transforming oil assets to be diversified into long-term financial investments. The initial funding for its establishment came through the transfer of 50% of the GRF's assets in 1976.

The FGF, therefore, manages a diversified portfolio of foreign marketable (bonds and equities) and alternative assets, with a savings objective. The fund has disclosed some information around its eligible assets and asset-class benchmarks, but is yet to disclose a detailed Strategic Asset Allocation and actual holdings. The KIO, a division of the KIA based in London, is responsible for in-house active portfolio management; and is complemented by a marketable securities and alternative investments team, based in Kuwait.

In contrast, the GRF is a much more complex institution, with a myriad of objectives and strategies. An overarching theme is the fund's clear and explicit developmental role in the domestic economy: it 'promotes and supports institutionalisation of the market through setting up funds and companies to promote and finance local business, and participates in the launching of local investments that have feasible economic returns'.

The fund's role in the local economy is also to support privatisation programmes run by the KIA, and the provision of liquidity to the treasury when needed. The development and expansion of the Kuwaiti financial sector is a particular area of emphasis: the 'KIA helps develop the role of local financial companies by giving them the opportunity to manage some of their investments locally and abroad'.

In the wake of the 2008 global financial crisis and the subsequent decline in global oil prices, there has been considerable pressure on the KIA to reduce its foreign holdings in favour of domestic investments. At the height of the crisis, the KIA even had to sell some of its foreign assets held through the FGF in order to stabilise the domestic economy and support local companies.

III. Source of funding

The GRF receives all government revenues, including all oil revenues and the GRF's investment income. From this initial allocation, funds are transferred to domestic investments, the general budget and the FGF. While there is a publicly disclosed rule for the percentage transferred to the FGF, the allocation of revenues between the general budget and domestic investments under the GRF is less transparent and rule based.

The FGF originally received 10% of state revenues, including investment income, from the GRF each year. Beginning in fiscal year 2012-2013, the Council of Ministers raised the deposit amount to 25%. This is known as a 'fixed percentage rule' approach to saving resource revenues and is similar to that used by the Alaska Permanent Fund. It is attractive, insofar as it is easy to communicate and monitor (where data is public), but it has the disadvantage of being mechanistic and non-responsive to the cyclical state of the economy or commodity prices/revenue since the government still has to transfer a portion of revenues in a low-revenue year.

IV. Liabilities

There are no formal withdrawal rules around the GRF, which essentially acts as part of the budget, and is, therefore, subject to the policies of the Ministry of Finance and approval by the national assembly. The only formal spending or transfer rule from the GRF is the requirement to transfer 25% of funds annually to the FGF, as outlined above.

The FGF's assets are, however, locked into the fund by law and investment returns are reinvested (Law No. 106 of 1976). The FGF is intended to meet future liabilities and spending needs, but these liabilities have not been made explicit or been formally defined. Doing so will require the national assembly to pass a specific authorisation law.

V. Governance structure

The KIA's governance structure is relatively clear and robust in certain aspects. However, there are some weaknesses that leave it, and the funds under its management, subject to ad hoc policies and changes. The KIA's size and track record (it is one of the world's long-standing sovereign funds) have made it a credible organisation, with a high degree of expertise and professionalism. Moreover, the KIA is accountable to a number of public institutions in Kuwait, who provide oversight of the organisation and its funds. In general, the oversight and reporting framework is comprehensive and involves a number of institutions, but public disclosure and transparency around the specifics of the KIA's saving and spending rules and its funds' portfolios, is limited.

External governance

i. Savings and spending rules:

As noted above, the GRF is the primary recipient of all public revenues in Kuwait, and the allocation of its funds to the budget and domestic investments are subject to the decisions of the minister of finance (who is also Chairman of the Board of the KIA) and approval by the Kuwaiti National Assembly. An annual 25% transfer of funds to the FGF is, however, mandated by law (this spending rule of the GRF is the mirror image of the FGF's savings rule).

There is currently no spending rule for the FGF, as the portfolio simply grows over time and investment income is reinvested – however, any anticipated future decision to deploy the FGF's assets and/or income will require the national assembly to pass a specific authorisation law. In general, the minister of finance, who serves as the Chairman of the Board of Directors of the KIA, has ultimate say around the spending and savings rule of the institution and its two funds, but is subject to approval by the national assembly. The presence of the governor of the central bank, other ministers and independently appointed officials. The Board of Directors of the KIA, also provides inter-institutional representation in the highest authority of the KIA.

ii. Placement and reporting lines within the public sector

The KIA is described by the Kuwaiti authorities as 'an independent public authority'. According to the KIA, its 'long-established autonomy... helps assure that its investment decisions are based strictly on commercial, rather than geopolitical, considerations.' The KIA's Board of Directors contains key ministers (including the minister of finance, who chairs the Board), the governor of the central bank and appointed independent officials – and the Board enjoys extensive oversight powers for the operational management and strategies of the KIA, and in appointing its most senior officials.

The management and operational staff of the KIA consist of civil servants who do not hold political office. Figure 1 shows the internal and external governance structures of the KIA. The KIA reports, through its Board of Directors, to the Council of Ministers, the national assembly and the state audit bureau. Senior representatives of KIA report periodically to the national assembly's various Committees (including the finance and economic Committee, budget Committee, and closing accounts Committee) to discuss any issues raised by the state audit bureau, who have on-site representatives working in the KIA. The KIAs accounts are reviewed, audited, and approved jointly by two of the world's leading external audit firms.

iii. Transparency and disclosure

The KIA has a self-expressed commitment to transparency and accountability, and provides periodic reporting to concerned parties. Much of the disclosure, however, is not made public but kept within the official sector, including annual reports to parliament. For example, 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, as well as to the national assembly'. Provisions in the law establishing the KIA (Law No. 47 of 1982) impose strong penalties and prohibitions around the disclosure of certain types of information on the KIA's activities. Inter-governmental reports, not disclosed to the public, include:

- Monthly, quarterly, semi-annual and annual statements to the Chairman of the Board of Directors and the Executive Committee of the Board;
- Quarterly, semi-annual and annual statements to the Board of Directors;
- Semi-annual statements to the state audit bureau;
- An annual statement of its accounts to the Council of Ministers (cabinet);
- An annual statement of its accounts to the national assembly (parliament);
- KIA representatives appear before various Committees of parliament on a periodic basis;
- External audits.

Internal governance

iv. Institutional governance

The Board of Directors, appointed by the Council of Ministers, has ultimate responsibility over the organisation and its funds. By law, the Board is chaired by the Minister of Finance and includes the minister of oil, the Fovernor of the Central Bank of Kuwait, and the under-secretary of the Ministry of Finance, as well as five other Kuwaiti nationals from the private sector (appointed by the Council of Ministers). At least three of these five appointees may not hold any other public office. The Board of Directors, in turn, appoints a Managing Director, assistant managers (who may not undertake any work for any employer other than KIA) and an Executive Committee. The Board of Director's main powers lie in:

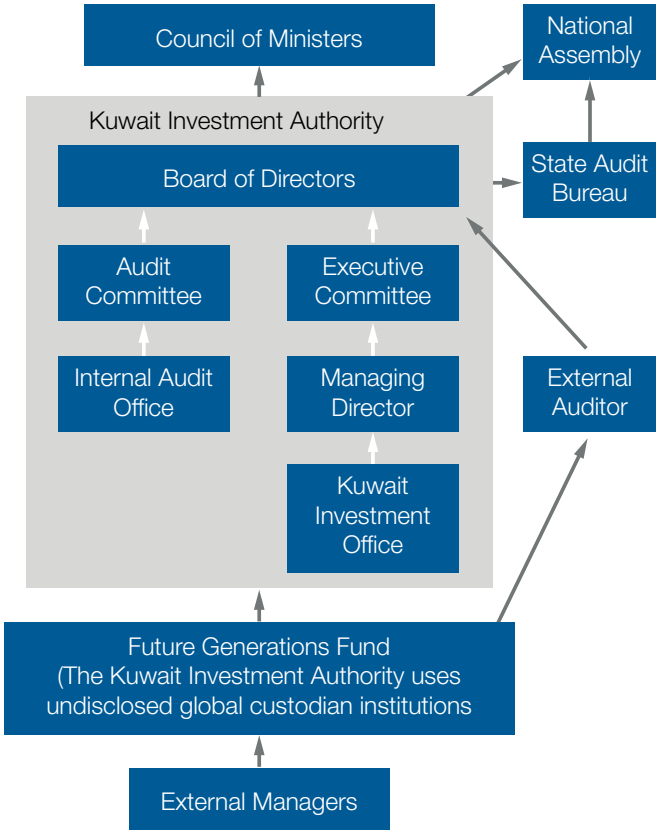
- Overseeing all aspects of the KIA;
- Approving strategic plans for the funds under its management constructed by the Executive Committee (including the approval of the funds' strategic asset allocation);
- Appointing the senior management of the KIA.

The Executive Committee is the highest operational authority of the KIA and is composed of five Board members (of whom at least three are taken from the private-sector appointees to the Board). The Managing Director of the KIA chairs the Executive Committee, whose primary role is to assist the Board of Directors in setting the strategic goals and objectives of the KIA.

The management of the KIA is further organised under the Managing Director's office, to which all senior management reports, including: the head of the London KIA, the heads of various Kuwait-based investment teams of the GRF and FGF, the risk and performance, the operational management, the legal affairs and audit department. Also under the auspices of the Managing Director's office is the strategy and planning department, which develops not only organisational strategies (five-year plans), business and financial plans; but is also responsible for various aspects of investment planning, including forecasts of monthly fund cash flows for the FGF and the GRF, the analysis of macroeconomic and financial-market trends, and the development of a tactical asset allocation.

Finally, the KIA also has an internal audit department, while the Board of Directors has an Audit Committee, with members from the private sector representatives of the Board. Both internal audit bodies report to the Chairman of the Board. The internal audit structures are complemented by external audits by two international audit firms.

Figure 1: Internal and external governance structure of the KIA



Source: KIA

v. Investment and risk management process

The Board of Directors is responsible for approving the KIA's strategic asset allocation, return targets and risk parameters, as suggested by the Executive Committee. In practice, the KIA has made use of international investment consultants to assist in the analysis of factors determining these key investment and risk management parameters; and the selection of performance benchmarks and external managers.

In implementing investment and risk management strategies within these parameters, the GRF and FGF have independent, dedicated Investment Committees. The strategy and planning department, which reports directly to the Managing Director and is managed by his office, also plays a particularly noteworthy set of functions with respect to medium- to long-term investment strategies, including:

- Analysing the global macroeconomy and financial markets;
- Monitoring the latest external developments in tactical asset allocation best practice;
- Using economic analysis to provide advice to the GRF and FGF Investment Committees.

The investment teams of the KIA are organised into four units, all reporting to the Managing Director. These four units and their own internal sub-divisions are as follows:

01. Kuwait Investment Office (operationally independent investment team based in London):
    - Equities;
    - Fixed income;
    - Private equity and fixed income;
    - Investment support;
    - Human resource and administration;
    - Middle office.

02. General Reserve Fund (domestic and regional investments):
    - Equity;
    - Real estate;
    - Loans;
    - Institutions and new investments;
    - Follow-up team.

03. Marketable Securities:
    - Equities;
    - Fixed income;
    - Treasury department;
    - Emerging markets;

04. Alternative Assets:
    - Private equity;
    - Real estate;
    - Hedge funds;

In terms of risk management, this largely falls under the control of the risk and performance team, which reports directly to the Managing Director's office, and monitors all investments of the GRF and FGF. The London-based KIO is an exception, in the sense that it has its own internal middle-office function.

VI. Investment style and strategy

The Kuwait office of KIA appoints global leading external fund managers to manage various mandates (especially for equities, bonds and cash asset classes) and also manages a portion of some asset classes in-house, through the London-based KIO. In select cases, KIA invests directly in equities classified as core holdings, such as its holdings in BP plc and Daimler AG.

The KIO manages its funds as a global investor, with investments in all the main geographical areas and asset classes managed by portfolio managers on an active basis. It is a long-term investor and the in-house investment management team covers equities, fixed income, treasury, private equity and property. The KIO aims to produce superior performance, relative to its benchmark, and within specific risk parameters.

The FGF invests outside Kuwait and the MENA region, and its investments are allocated among various asset classes in line with its strategic asset allocation established by the Board of Directors. The strategic asset allocation is based on allocations among: (i) regions (based generally on world GDP contributions), (ii) different asset classes, and (iii) different types of fixed income assets. The KIA does not invest in sectors where gaming or alcohol-related activities constitute the main source of business. In addition, investments in venture capital firms are prohibited.

Norway:
Government Pension Fund Global

▶ Key features

- The Norwegian Government Pension Fund Global (GPFG) is one of the world's largest and most successful sovereign wealth funds (SWFs), with some $850 billion in assets as at October 2014. It forms a critical part of the prudent management of oil and gas wealth that has made Norway one of the world's richest countries;
- The GPFG performs both budget-stabilisation and saving (as well as implicit counter-Dutch disease) functions. Given its level of development, diversification and alternative fiscal revenue sources, the degree of saving of oil revenues through Norway's SWF is very high;
- The fund is an integrated part of the government's annual budget, with income from the GPFG providing stable, predictable funding of up to 4% of the fund's capital in the annual national budget. This equates to around 6% of the GDP non-oil budget deficit;
- The GPFG's capital has grown sharply to $850 billion (and continues to grow): its capital is not explicitly earmarked (it is not a pension reserve fund), but there is frequent mention of future demographic challenges that the fund may be used to meet;
- The fund is managed from within Norway's central bank (Norges Bank) on behalf of the Ministry of Finance and is lauded globally for its highly transparent operations and governance models. From 1 October 2014, the GPFG introduced a new structure consisting of three chief investment officers; a dedicated chief compliance officer separate to the chief risk officer and a dedicated real estate 'leader group' with a new head;
- The GPFG's portfolio is invested abroad and has guideline allocation of: 60% equities; 35%-40% fixed Income and up to 5% real estate;
- The fund generated an annualised return of 5.7% from 1998, when Norges Bank Investment Management (NBIM) was established, to the end of 2013. After management costs and inflation, the real return was 3.6%.

Fund snapshot

Year Established	1990	
Assets Under Management	$850 billion (Oct 2014)	
Source of Funds	Commodity revenues	
Portfolio at a glance (as at June 2014)	Equities	61.3%
	Fixed Income	37.6%
	Real estate	1.2%

I. Background: Economic and political context

Oil was discovered in the Norwegian North Sea territory in 1969 (production commenced two years later), but the idea of a sovereign wealth fund was only introduced in 1990, when the Government Petroleum Fund was created through an act of parliament (the first transfers to the fund only occurred in 1996). The fund's portfolio is managed by a dedicated fund management unit, NBIM within the central bank, Norges Bank. Initially, the portfolio was managed in a highly conservative manner in line with the Norwegian central bank's foreign exchange reserves. Over the past 15 years, the fund's investment practices have continually become more sophisticated, moving from an equities-only portfolio in 1998 to a more diversified portfolio today that also boasts fixed income and real estate assets.

The allocation of oil revenues to Norway's sovereign fund and the flow of investment income from the fund to the budget, is governed by a fiscal-rule framework implemented by the Norwegian Ministry of Finance, with parliamentary approval. Major reforms to the fund, including the change of its name to the Government Pension Fund Global, were made through a new law in 2005, which clarified the fund's objectives and management responsibilities. In 2007, the fund significantly increased its strategic allocation to equities to 60% (from a previous maximum of 40%). Small-cap equities, emerging market bonds and equities, and real estate allocations have all been added subsequently.

It is noteworthy that Norway was already well developed (economically and institutionally) at the time oil was discovered. Its economy was well-diversified, with a number of existing alternative sources of fiscal revenues (value-added, personal-income and corporate taxes). Oil revenues (even before transfers to the GPFG) have never dominated other sources of fiscal revenues: over the past decade, for example, oil-related revenues accounted for roughly 37% of total revenue (which was all transferred to the GPFG, whose reimbursements to the budget amounted to around 9% of revenue). Tax revenue remains more or less equally distributed (one quarter each) between value-added, personal-income, non-oil corporate and oil-sector corporate taxes.

The Norwegian fund serves several purposes. First, it prevents fiscal (and broader macroeconomic) instability by insulating the fiscal process from resource revenue volatility, as all such revenue is transferred to the fund and only the long-term expected real return on the fund's capital (the 'permanent income') is redistributed to the budget. A second motivation for the fund was ethical: the desire to promote a more equitable distribution of revenues from a finite source across successive generations. The architects of the Norwegian fund were also deeply aware of a possible loss of export competitiveness due to resource windfalls and the impact of Dutch disease.

The Norwegian SWF's exemplary transparency is unsurprising, given the highly democratic character of the country's economic and political institutions, and the accountable, transparent nature of its politics. Norway's high degree of economic development and diversification at the time of resource discovery enabled the architect of its SWF to clearly articulate the fund's role as: (i) providing a stable source of fiscal revenue in the form of investment income (based on real returns); and (ii) saving a large portion of revenues for future generations. The Norwegian authorities have justified the importance of these roles in light of a number of structural characteristics of the Norwegian economy, including: the volatile nature of resource-related revenue, an anticipated decline in oil and gas revenues, and the financial challenges of an ageing population (as discussed below, the GPFG's assets are, however, not formally linked to pension or any other liability, despite the fund's name).

II. Official mandate(s)

The GPFG serves both a stabilisation and savings function:

01. It provides stability by transferring all annual resource-related revenues (which can be highly volatile) to the fund; and reallocating a stable and predictable amount of investment, equal to 4% of the fund's value (i.e. permanent income), back to the budget;

02. The fund also serves as a savings function, as the fund's capital has risen sharply since inception, on the basis of retained investment returns (in excess of 4% p.a.) and sustained net inflows of resource revenues.

The fund's broad **institutional mandate** can, therefore, be described as a hybrid savings/stabilisation fund. The fund also implicitly serves another function, linked to stabilisation, of preventing a sudden loss of competitiveness due to oil exports and windfall revenues (Dutch disease). As the Ministry of Finance states, 'By investing the fund in international currencies, we shelter the mainland economy and the Norwegian krone exchange rate from the large and variable cash flows from the petroleum sector. This contributes to preventing the petroleum sector from causing the excessive displacement of mainland export-oriented industries'.

It is noteworthy that the fund's stabilisation function is achieved through the stable transfer rule around the fund's permanent income (the 'spending rule'), rather than by maintaining a portfolio of highly liquid assets. Consequently, the fund has an **investment mandate** that allows it to much focus on long-term returns, with relatively little concern for short-term volatility. Indeed, the fund 'seeks to take advantage of its long-term outlook'. The fund is very explicit about the fact that its investment strategy 'is not aimed at minimising the return volatility', as this would 'produce a significantly lower expected return'.

The GPFG is clear that it has 'a greater ability to bear risk than many other investors [because] the fund has no clearly defined future liabilities, as well as a very long time horizon'. The fund is also expected to be able to capitalise on scale benefits (it is one of the largest institutional investors in the global financial markets), and has a highly diversified portfolio across asset classes, risk factors, regions and individual assets. With its long-term orientation, scale benefits and diversified portfolio, the GPFG has a long-run real return target and expected return of 4% (the basis of its spending rule). As discussed below, the GPFG also has a strong mandate to pursue ethical investments.

III. Source of funding

The GPFG is a classic resources-based sovereign fund that invests fiscal revenues from the country's oil and gas sector. The primary source of funding is taxes and royalties on oil and gas production (100% of government petroleum revenue is transferred to the GPFG). The fund also manages net revenues from the government's sale of shares in Statoil, the national oil company, and other government equity in the sector. Finally, the fund manages retained investment returns on its investments (in excess of the 4% of assets transferred to the budget annually).

Norway transfers an exceptionally large portion of its resource revenues to its sovereign fund, given its high level of development, strong existing public infrastructure and ample alternative sources of fiscal revenue. Indeed, the process for allocating resource revenues starts with the transfer of all revenues to the fund – that is, Norway formulates its annual budget without any resource revenues in the form of the so-called 'structural non-oil budget'. As discussed in the following section, a deficit of up to 4% of the size of the SWF is permitted on the structural non-oil budget, which can be financed by a transfer from the fund. The Norwegian Ministry of Finance estimates that over the past decade, oil-related revenues accounted for roughly 37% of total fiscal revenue, while transfers back to the budget from the GPFG accounted for around 9% of total revenue.

IV. Liabilities

The Norwegian GPFG's assets are not explicitly linked to any liabilities, either short- or long-term. Despite the 'pension' in its title, there are no formal links in law or any official documentation between the fund and future pension liabilities – and certainly no formal asset-and-liabilities modelling of the fund's portfolio. That said, an implicit link to future pension liabilities is inferred through the fund's name and the frequent mention of long-term pressures on the Norwegian social safety net due to challenging demographics associated with an aging population.

In addition to these implicit long-term liabilities, the fund's annual transfers to the general budget – currently capped at 4% of total fund capital (deemed to be an appropriate long-term real return on the fund's portfolio) – serves as an explicit short-term liability. However, this liability is small relative to the fund's total assets. That means the fund's portfolio is not greatly constrained by the need to maintain significant liquid assets. The 4% of transferred capital can finance a deficit on the non-oil structural deficit. This potential transfer is not insignificant given the massive size of the fund: at its current size of $850 billion, a 4% transfer amounts to around $33.5 billion in redistributed fiscal revenue that goes back into the budget to cover the non-oil structural deficit. This should allow Norway to finance a structural non-oil deficit as high as 6% of GDP in 2014 – although the Ministry of Finance has kept that deficit between 4.4%-5.3% of GDP (or 3.3%-3.9% of the fund) since 2010 (See Table 1 over).

Table 1: The Norwegian sovereign wealth fund and the structural non-oil deficit

	CURRENT PRICES			CONSTANT 2013 PRICES			STRUCTURAL DEFICIT	
	Goverment Pensions Fund Global at the begining of the year[1]	Expected return (4 pct. on the Fund capital)	Structural, non-oil budget deficit	Expected return (4 pct. on the Fund capital)	Structural, non-oil budget deficit	Deviation from the 4 pct. trajectory	As pct. Mainland Norway trend-GDP	As pct. the Fund capital
2001	386.6	-	21.7	-	34.1	-	1.9	-
2002	619.3	24.8	36.7	37.3	55.3	17.9	3.0	5.9
2003	604.6	24.2	43.2	35.0	62.5	27.5	3.3	7.1
2004	847.1	33.9	47.1	47.7	66.3	18.7	3.4	5.6
2005	1011.5	40.5	49.3	55.2	67.3	12.1	3.3	4.9
2006	1390.1	55.6	45.7	73.2	60.2	-13.0	2.9	3.3
2007	1782.8	71.3	46.9	89.6	59.0	-30.7	2.8	2.6
2008	2018.5	80.7	57.3	95.7	67.9	-27.7	3.2	2.8
2009	2279.6	91.2	96.1	104.1	109.7	5.6	5.1	4.2
2010	2642.0	105.7	102.4	116.6	113.0	-3.6	5.1	3.9
2011	3080.9	123.2	92.6	131.2	98.6	-32.6	4.4	3.0
2012	3307.9	132.3	116.2	136.6	120.0	-16.6	5.2	3.5
2013	3793.1	151.7	125.3	151.7	125.3	-26.4	5.3	3.3
2014	4280.7	171.2	-	165.8	-	-	-	-
2015	4641.4	185.7	-	174.1	-	-	-	-
2016	4954.6	198.2	-	179.9	-	-	-	-
2017	5275.2	211.0	-	185.4	-	-	-	-
2018	5600.2	224.0	-	190.5	-	-	-	-
2019	5926.9	237.1	-	195.2	-	-	-	-
2020	6262.3	250.5	-	199.6	-	-	-	

Source: Norwegian Ministry of Finance; note that values after 2013 are official forecasts, as of June 2014.

V. Governance structure

As has been widely noted in the literature on SWFs, Norway has exemplary governance arrangements, both internally (in terms of its corporate governance arrangements) and externally (in terms of oversight mechanisms by the state and public). While other funds may find it difficult to implement similar governance structures given political constraints and local public-sector practices, the Norwegian governance structure offers an exceptionally robust model to emulate. These governance arrangements have been dynamic, evolving in line with changes to the investment strategy and size of the fund. In 2014, the GPFG created several new senior positions as well as a real estate investment group, mandated to develop and hone the niche skills demanded by this asset class.

External governance

i. Savings and spending rules

The flow of oil revenues and investment income in and out of the Norwegian fund are determined by the fiscal-rule framework, proposed by the Ministry of Finance (initially in 2001), and adopted by parliament. Both the saving rule (i.e., the transfer of all oil revenues to the sovereign fund) and the spending rule (i.e., 4% of the fund's capital) are, therefore, not legally binding, but have rather emerged through a broad consensus around the prudence of the fiscal rules. It is clear, however, that the governance of the saving and spending rule is rule-based and enjoys the support of the Ministry of Finance, the parliament and NBIM. That said, this rule-based framework is largely consensual and can, in theory, be changed if the relevant parties agree.

The spending rule in particular is subject to change, as it is based on the expected sustainable long-term real return of the fund. The Ministry of Finance, NBIM and external experts have agreed in recent years that a 4% annual real return is feasible, and is an appropriate amount to transfer (as permanent income) back to government to finance the non-oil structural deficit. However, this expectation is potentially dynamic; and in late 2013, for example, the governor of Norges Bank suggested that the figure may have to be lowered to 3% per annum due to lower returns in global financial markets. The process of changing the spending rule in light of lower expected returns on the portfolio would involve external consultation and research, but is likely to be driven by the Ministry of Finance and NBIM, in consultation with parliament. It appears that there is a strong institutional bias towards preserving the 4% return assumption/spending rule: the Norwegian Finance Minister, for example, has dismissed calls to lower the rate to 3%, arguing that it would set a precedent to subsequently raise it to 5% or 6%.

ii. Placement and reporting lines within the public sector

The Norwegian model involves a number of public institutions, each with clearly defined roles and responsibilities, and exceptionally high reporting and disclosure requirements and practices. The inter-institutional model involves: the Norwegian parliament, the Ministry of Finance, the executive Board of the central bank, a dedicated operational investment manager (under the auspices of the central bank), a supervisory council, and public and private auditors. The reporting lines between these institutions are shown in Figure 2, and briefly described as follows:

– The Norwegian Parliament passes legislation governing the fund, approves the annual budget, appoints the supervisory council members and reviews reports on the fund's guidelines, strategies and investment performance prepared by the Ministry of Finance, the fund's operational investment manager and auditors;

– The Minister of Finance acts as fund 'owner'. It delegates operational management to the Norges Bank (the central bank) within a clearly articulated mandate that includes investment guidelines, ethical management, risk management and internal control. It monitors and evaluates fund performance;

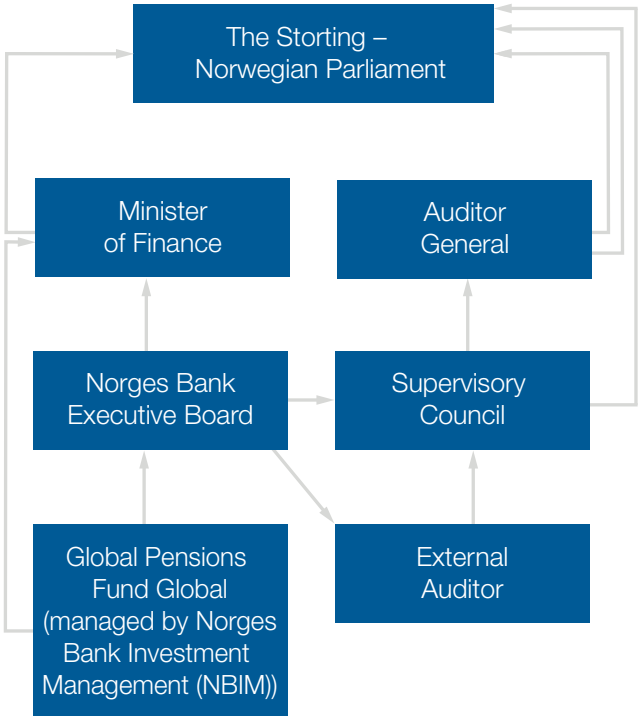
– The **Central Bank Executive Board** is the fund's operational manager, overseeing NBIM, the dedicated investment management unit within the central bank. It generates the fund's investment mandate and outlines principles of risk management, asset allocations and internal management for NBIM. The executive Board is subject to an internal audit;

– **NBIM** is a department within the central bank and is the day-to-day, operational fund manager (it also manages other public funds and the central bank's foreign exchange reserves). It implements investment strategy and exercises active management. NBIM submits a strategic plan directly to the minister of finance for approval;

– The **Supervisory Council** supervises the central bank's activities and ensures that the rules governing operations are observed. It has right of access to information and investigative powers. It reports to the parliament, which also appoints the 15 members of the council. Appointments are for four-year terms with the possibility of re-appointment twice (12 years maximum). Every other year, up to half of the membership is reappointed or replaced. The Chairman and deputy Chairman are appointed for two-year terms;

– The **Auditor General** performs an audit of the fund and the operations of NBIM, and reports to the parliament and the government. An **external auditor** is appointed and reports to the Supervisory Council.

Figure 1: The inter-institutional reporting structure for the Norwegian sovereign wealth fund



Source: NBIM and the Norwegian Ministry of Finance

iii. Transparency and disclosure

The GPFG is the poster child for sovereign wealth fund transparency, disclosing an exceptional amount of information about its governance, operations, strategies, investment holdings and performance. Most of these disclosures are mandated by law – including, most prominently, quarterly and annual reports that are required to include information on all the fund's accounts and portfolio. The Ministry of Finance reports at least annually (and often more frequently) to parliament on the fund's operations, strategies and performance. In addition to these extensive formal disclosure and reporting requirements, the ministry and NBIM produce a large amount of supplementary information of all aspects of the fund, regularly uploaded to the fund website.

NBIM also produces regular information on its external fund managers, fees, compensation, and evaluations and criticisms by independent analysts and academics; while audits are also made available to the public. Officials from the Ministry of Finance, the central bank and NBIM frequently make public speeches and interact with the media about the fund. Real-time information of the size of the fund is available on the NBIM website. Perhaps most remarkable is the extent of NBIM's disclosure and discussion of its own investment performance. The fund's past performance is disclosed in full, and NBIM provides detailed analysis not only of absolute performance and the fund's actual
holdings and portfolio, but also cost- and fee-adjusted information of the value-added, relative to its benchmarks and target portfolio, by active management. It also releases independent audits and assessments of the fund's performance.

Internal governance

iv. Institutional governance

The internal governance process of NBIM involves four levels of authority:

– The Executive Board is NBIM's highest internal governing body, which sets the investment mandate for the fund, and the chief executive officer's job description and appointment. The executive Board also approves the organisation's three-year strategy plan. The executive Board is chaired by the governor of the central bank with the deputy governor of Norges Bank as vice-Chairman and five external members (academics, labour representatives and business leaders) appointed by the King of Norway;
– The Chief Executive Officer/Executive Director reports directly to the executive Board and has overall responsibility for implementing the Board's requirements. He is the highest managerial authority in NBIM and is responsible for the supervision and job descriptions of the Leader Group;
– The Leader Group is the organisation's senior executive Management Committee, comprising the chief executive, chief investment officers, chief administrative officer, chief risk officer, chief operating officer and the newly operational chief compliance officer. The group is responsible for line management, 'reporting up' to the chief executive, and coordination between units in the organisation;
– The Leader Group is responsible for six Management Committees and a risk and compliance unit. These Committees and the compliance unit act as advisory forums for chief executive officer decisions related to a number of key areas relevant for an investment management organisation (see the Investment Process section later on).

The internal governance model of NBIM differs from other parts of the central bank, in the sense that NBIM's executive Director is also the chief executive officer of this investment unit, who reports directly to the executive Board and is subject to continuous oversight by the bank governor on behalf of the Board. This direct reporting line to the governor and the executive Board, as well as the chief executive officer role assigned to the head of NBIM, underlines the extent to which the investment unit acts autonomously from the rest of the central bank. The current key leadership positions are set out in Table 2. The new roles created for the October 2014 restructure, and the background of the personnel appointed to these positions, demonstrate GPFG's growing commitment to the real estate asset class and strong focus on risk and compliance.

Table 2: GPFG 'Leader Group' personnel following 2014 restructure

ROLE	NAME	APPOINTED	FORMER GPFG ROLES
CEO/Executive Director	Yngve Slyngstad	Jan 2008	1998-2007: Head of Equities
Deputy CEO and Chief Administrative Officer*	Trond Grande	Deputy CEO: Feb 2011 CAO: 1 Oct 2014*	2011-2014: Chief of Staff 2009-2011: Chief Risk Officer 2007-2009: Global Head of Risk Management
CIO (Equity Strategies)	Petter Johnsen	April 2011	2010-2011: Global head of sector strategies 2003-2010: Portfolio manager
CIO (Real Estate)	Karsten Kallevig	April 2011	2010-2011: Global Head of Real Estate Asset Strategies
CIO (Asset Strategies)*	Oyvind Schanke	1 Oct 2014	2008-2014: Global Head of Equity Trading; 2001-2008: Senior Trader
CIO (Allocation Strategies)*	Ole-Christian Bech-Moen	1 Oct 2014	2012-2014: Global Head, Allocation Strategies 2009-2012: Global Head of Macro & Portfolio Research; Senior Analyst
COO (Real Estate)*	Nina Hammerstad	1 Oct 2014	2011-2014: Head of Real Estate Asset Management
Chief Administrative Officer (Real Estate)*	Mie Holstad	1 Oct 2014	2011-2014: Real Estate Asset team 2010-2011: Control and Compliance
CRO*	Dag Huse	1 Oct 2014	2012-2014: Global Head of Investment Risk 2003-2012: Senior Portfolio Manager
COO	Age Bakker	Oct 2009	2009: Global Head of IT

* New appointments/roles effective as of 1 Oct 2014
Source: NBIM

v. Investment and risk management process

As is the case for the governance of the NBIM and the GPFG in general, the investment and risk management process is characterised by a high degree of inter-institutional oversight, delegation and reporting. As noted above, the Ministry of Finance sets the fund's broad investment guidelines and risk-management parameters, in line with the mandate and objective specified in law. This mandate is then further refined by NBIM: first by the executive Board and, then in greater detail by the chief executive, the Leader Group and the Management Committees. In all cases, there is a hierarchical chain of approval, leading back to the Ministry of Finance. The inclusion of a new asset class, for example, may be proposed by NBIM, following its own internal analysis, but requires approval both from the Executive Committee and the Ministry of Finance (in consultation with parliament).

Bottom-up information, analysis and guidance on the investment and risk management processes is provided through five of the six Management Committees of NBIM (the sixth Committee is focused on internal management issues related to remuneration and compensation), which reflect those of the typical institutional investor:

– Investment Risk Committee;

– Investment Universe Committee;

– Real Estate Committee;

– Business Risk Committee;

– Valuation Committee.

In addition to these Committees (which includes Investment and Business Risk Committees, which are more analytical in nature), NBIM has a separate risk management and compliance unit, which serves a more day-to-day monitoring and internal-control function.

VI. Investment style and strategy

The GPFG is one of the world's largest institutional investors, with a strong bias toward benchmark-driven investments in public bond and equity markets. The fund does attempt to add value through active management (internal and outsourced mandates), but such efforts are constrained by reference to portfolio benchmarks and concentration limits.

Since 2010, the fund's target portfolio has a 60% allocation to equities, 35% to bonds and 5% to real estate (as of October 2014, it had only realised 1.2% real estate investment). Previously, the split was a simple 60/40 bond/equity split. The Ministry of Finance and NBIM, in their respective capacities as the owner and manager of the fund, have articulated an investment strategy with the following characteristics:

– Harvesting risk premiums over time;

– Diversification of investments;

– Exploitation of the fund's long investment horizon;

– Responsible investment practices;

– Cost effectiveness;

– A moderate degree of active management

– A clear governance structure.

The Norwegian sovereign fund is also famous for its policies with respect to ethical or responsible investment – notably, its exclusion of companies it deems to be unethical. The Ministry of Finance decides on the exclusion of companies from the fund's investment universe, or to place them on an observation list. The decisions are based on recommendations from the Council of Ethics established by royal decree. Prominent elements of the fund's approach to responsible investment include:

– An active approach to shareholder right (and demand for equal treatment of shareholders and Board accountability);

– A concern for the protection of children's rights;

– A concern for the impact of its investment on climate change and water supplies.

Saudi Arabia: SAMA

▶ Key features

- The Saudi Arabian Monetary Agency (SAMA) is the Kingdom of Saudi Arabia's central bank. With more than $800 billion in reserves as at as of October 2014, SAMA boasts the world's 3rd largest reserves, after China's PBOC with $3.8 trillion and Japan with $1.2 trillion;
- Saudi has the largest proven oil reserves in the world, is the biggest oil producer within the Organisation of Petroleum Exporting Countries (OPEC) and the leading oil exporter of the Gulf Cooperation Council;
- Saudi Arabia is unusual both among large commodity-exporting countries and its peer states in the Gulf, such as the UAE, Kuwait and Qatar, for not creating a separate sovereign fund to help save and augment its resource revenues for future generations;
- Instead, SAMA has been tasked with the role of sovereign wealth management, alongside its traditional central bank responsibilities, similar to China's SAFE and the HKMA. It does so without explicitly separating its assets into different tranches or portfolios to meet these distinct objectives;
- SAMA is a conservative, but relatively diversified investor, with holdings in equities, bonds and alternatives. Given the Saudi economy's high exposure to global oil markets, SAMA's primary goal is to help shelter the domestic economy from volatility and external shocks and therefore much of the portfolio is held in sovereign bonds;
- There are several other government-owned investment vehicles in Saudi Arabia, none of which count as an SWF:
  - The Public Investment Fund (PIF) established in 1971 to facilitate the development of the Saudi economy excluded as SWFs given their domestic developmental mandates;
  - Sanabil, created in 2008, as a small subsidiary of the PIF with $5.3 billion in seed capital, to invest abroad. Very little information is available on the Sanabil investment style, but it is understood to be a long-term, risk-taking investor with heavy use of external advisors. Its full ownership by the PIF and limited seed capital, discounts it from being characterised as an SWF.

Fund snapshot

Year Established	1952
Assets Under Management (as at Oct 2014)	In excess of $800 billion (Total AUM of central bank)
Source of Funds	Oil

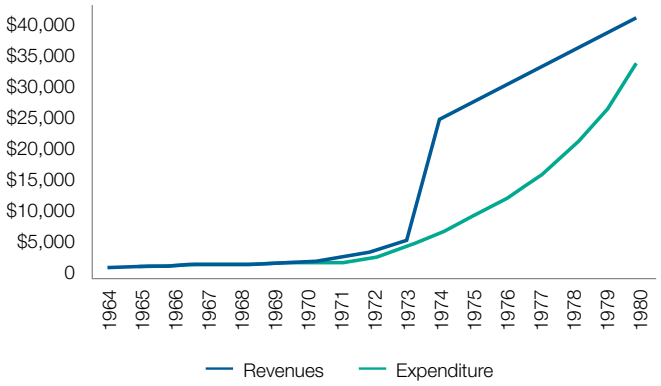
I. Overview: Political and economic context

The sale of Saudi oil began in 1948, resulting in a rapid increase in government revenues. Between 1938 and 1946, approximate annual government revenue totalled between £5 million and £6 million . In 1947-48, it had more than tripled, reaching £21.5 million. SAMA was established in 1952 by Saudi Arabia's founder, King Abdulaziz Al-Saud, to help manage this massive influx of petrodollars. US government officials on a financial mission to Saudi Arabia advised King Abdulaziz that it was crucial for the state to have monetary and banking regulations, as well as its own central bank. Plans for SAMA were drawn up and it was established by royal decree on 20 April 1952.

1960s-1970s: Emergence of Saudi Arabia as financial giant

Since the 1960s, Saudi oil income progressed steadily over the next two decades, mainly driven by increases in oil production. King Faisal's ascent to the throne in 1964 marked the beginning of Saudi Arabia as a modern economy as he embarked upon an ambitious programme of economic reform and modernisation. These reforms saw Saudi Arabia emerge in the 1970s as an international financial giant. Enhanced government revenues from rapid development of the oil production sector, and a more conservative approach to government saving by King Faisal allowed the Kingdom to amass vast wealth. As Figure 1 shows, government revenues reached historically high levels in the 1970s.

Figure 1: Saudi government revenues and expenditures 1964-1980 (US $ million)



Source: SAMA Annual Report (1982) cited in Bazoobandi (2013)

SAMA's revenues escalated rapidly in the 1970s and 1980s with the oil price boom and solid investment returns. The mid-1970s saw historically high levels of government revenue following the oil boom of 1973 and a high rate of crude exports from Saudi Arabia. By 1980, Saudi oil revenue had risen to $102 billion from just $3 billion in 1972, following a dramatic increase in the oil price over that same period, from $3 to $35 per barrel in 1980[1].

1980s-1990s: Decline of oil revenues and near-bankruptcy

The 1980s and early 1990s were a period of real financial difficulty for Saudi Arabia and SAMA given the volatility in global oil prices and the 1991 Gulf War. While the Saudi economy's dependence on oil revenue had delivered huge benefits in the 1970s, it caused great difficulty for the country in the following decade. Between 1980 and 1986, global oil prices declined by about 60% resulting in a sharp drop in Saudi oil revenue from around $113 billion in 1981 to $20 billion in 1986. This huge fall in revenue, alongside continuing high government expenditure, resulted in massive budget deficits for Saudi Arabia. As Table 1 above shows, the Saudi government substantially increased its expenditure from the early 1970s as oil income grew. However, these high expenditure levels continued throughout the 1980s despite the oil revenue shrinking. The government borrowed heavily to cover the deficit, but with the start of the Gulf War and the financing of ambitious development plans, Saudi Arabia encountered significant financial difficulty in the early 1990s and was forced to dramatically tighten its financial belt. During this period, SAMA's reserves dropped below $40 billion, close to the minimum necessary for currency backing at the time and there was high speculation on the Saudi Riyal's devaluation. The volatility in oil revenue income also had a direct effect on SAMA's foreign asset levels.

1995-2008: Recovery

Had this decline in oil prices lasted longer, the country would have faced extreme financial difficulty. Luckily, by the mid-1990s, Saudi Arabia and SAMA's financial position began to improve following the end of the Gulf War and the recovery in global oil prices. With the dramatic increase in oil prices between 2005-2008, the Saudi government's income rose sharply again. SAMA's reserves exceeded $500 billion.

2008-2011: Surviving the crisis and wealth accumulation

While assets levels decreased, SAMA fared relatively well during the crisis as a result of prudent management and its overweight exposure to high-quality sovereign bonds SAMA experienced smaller losses on its portfolio in comparison with other sovereign funds. Moreover, the government's commitment to reduce debt by cutting spending continued to reap benefits, resulting in a period of impressive wealth accumulation for SAMA.

2011-2014: A new sovereign fund?

As SAMA stockpiles increasingly large amounts of capital, debate has begun on whether the country should establish a dedicated savings fund, separate to SAMA, to establish an alternative source of permanent income for the government.

II. Official mandate(s)

SAMA's fundamental mission is to protect the Saudi domestic economy against oil price shocks through prudent management of the Kingdom's foreign exchange reserves. In addition to this income stabilisation role, SAMA also fulfils a sovereign wealth management function, pursuing higher returns on a portion of the country's 'surplus' sovereign wealth.

Its institutional mandate consists of the core tasks of any central bank including:

- Monetary stabilisation through maintaining the value of the Saudi riyal, issuing national currency, strengthening the currency's cover and acting as a banker to the government;
- Promoting the growth of the financial system and ensuring its soundness;
- Regulating and supervising the country's banking system.

In addition, the SAMA has a sovereign wealth management role. SAMA explicitly resists the SWF label, despite some commentators classifying it as such.

SAMA's key investment mandate is two-fold:

01. To maintain the initial value of assets through safe investments in assets with lower risk-adjusted return;

02. To enhance wealth accumulation from commodity export income through investment in assets with higher risk-adjusted return.

As SAMA's main purpose is to preserve foreign reserves to help insulate the domestic economy against economic shocks, the majority of its assets are managed with a mandate to ensure safety and liquidity. However, a tranche of funding is allocated to higher risk investments with a view to appreciating the country's sovereign wealth.

III. Source of funding

SAMA's primary source of wealth is commodity export income. The majority of the country's export earnings go towards the country's substantial domestic public spending commitments, leaving SAMA with whatever remains of the state's oil proceeds in any given year.

Unlike Kuwait and Abu Dhabi, the Saudi government has never introduced a rule based approach to saving and spending oil revenues. Instead, SAMA's financing source is, effectively, the residual of actual spending. In this sense, any accumulation of resource wealth is an accidental bi-product of discretionary spending decisions made by the Ministry of Finance annually.

IV. Liabilities

In addition to the standard liabilities of a central bank, SAMA's asset levels are negatively affected by the substantial public spending commitments of the Saudi government. These arrangements mean that social spending in Saudi Arabia amounts to an indirect drawdown on SAMA's asset base. In other words, SAMA has indirect liabilities, since its assets are not insulated in a sovereign wealth fund or protected through a fiscal rule, regulating saving and spending of oil revenue.

V. Governance structure

Today, SAMA is one of the largest central banks in the world. The King is responsible for appointing Board members, including the governor and vice-governor, following recommendations from the finance minister. SAMA enjoys relative independence in its management. For the first 22 years of its existence, non-Saudis managed SAMA, due to insufficient local expertise. The first two governors were American and the third was of Pakistani origin. Consequently, SAMA has a long track record in staffing its central bank with well-qualified, technical experts.

External governance

i. Savings and spending rules

There are no formal rules governing the proportion of oil revenue that must be transferred to SAMA for saving. Similarly, there are no rules governing the spending of oil revenue. In that sense, Saudi Arabia suffers from the absence of a rule-based fiscal framework for managing its oil revenues, particularly as Saudi Arabia has reached stable levels of production and is largely dependent on price-driven increases in oil revenue
(see Table 1).

There have also been no discretionary transfers or allocations to SAMA. Instead, the Saudi Arabian government has varied spending levels at its own discretion. For instance, public spending dramatically increased throughout the 1970s and 1980s, in line with rising oil income, but was not moderated when oil revenue levels subsequently declined. This discretionary approach to saving and spending of commodity wealth is in contrast to the rule-governed regimes of states like Norway, Chile, Abu Dhabi and Kuwait.

Table 1: Saudi Arabia oil revenues and average oil price
(nominal US$ billion)

YEAR	SAUDI ARABIA OIL REVENUES	AVERAGE OIL PRICE[1]
2000	57.2	30.4
2001	49.0	26.0
2002	44.3	26.2
2003	61.6	31.1
2004	88.0	41.5
2005	134.5	56.6
2006	161.2	66.1
2007	149.9	72.3
2008	262.2	99.7
2009	115.8	62.0
2010	178.7	79.5
2011	275.8	94.9
2012	305.3	94.1
2013	276.0	98.0

Source: IMF and World Bank
1. The average annual dollar per barrel spot price for West Texas Intermediate, provided by the US Energy Information Administration.

ii. Placement and reporting lines within the public sector

SAMA produces an annual report, which is presented to the King. This is SAMA's only formal reporting obligation. In practice, SAMA is operationally independent, but administratively, it reports to the Minister of Finance who is responsible for overseeing its workings. There are virtually no mechanisms for monitoring the Minister of Finance in this role. The Governor of SAMA is not legally required to report to the Minister of Finance, but does so on an understanding that it is an appropriate action. To date, the highest authority in the Kingdom has played little role in monitoring the workings and running of SAMA – especially with regard to its management of reserves and sovereign assets.

iii. Transparency and disclosure

SAMA's approach to transparency and disclosure is mixed. Since 1961, SAMA has produced a relatively detailed annual report, including statistical data about the organisation's foreign holdings. This has resulted in a more transparent approach to foreign asset allocation compared to other GCC commodity-based funds. However, SAMA is still relatively opaque when it comes to information on its investment decision-making process and behaviour. The annual reports reveal an impressive information-gathering system on Saudi's public finances, but tend to focus on statistical data about the Saudi Arabian economy, rather than the internal governance arrangements and procedures of SAMA.

Internal governance

iv. Institutional governance

SAMA's highest governing body is a five-member Board of Directors (See Figure 2). All five members are appointed by royal decree. The governor (the effective Chief Executive Officer and Chairman of the Board) and Vice Governor are appointed for a (renewable) term of four years, with the other three Directors selected from the private sector and appointed for five years. The Finance Minister and Governor advise the King regarding recommendations for appointments.

SAMA's Board of Directors is largely symbolic, with little legal or actual responsibility for decision-making and oversight of the fund. Instead, power is concentrated in the hands of the governor of SAMA and Minister of Finance. The centralisation of power is also evident in the comparatively small size of SAMA's Board, relative to the larger Boards of many sovereign funds that often contain between seven and fifteen Directors, and the lack of separation between the roles of Chairman of the Board and Chief Executive Officer of SAMA, both undertaken by the governor.

v. Investment and risk management process

SAMA's investment and risk management process is not rule-governed. There is an Investment Committee that periodically, consisting of senior personnel from the investment department and deputy governors. This Committee makes recommendations to the governor, and the vice-governor if in attendance. The governor may follow the advice at his discretion since the governor is both chief executive officer and Board Chairman. The other Board Directors have no influence or say over investment decisions, as the SAMA charter only mandates them with the general central bank oversight.

VI. Investment style and strategy

Relative to its peer funds within the GCC, SAMA is a low-risk, conservative investor, albeit one that is more diversified than typically appreciated. In addition to some holdings in bank deposits and certificates of deposit to meet liquidity needs, SAMA has holdings in bonds, equities and alternatives. Due to SAMA's stabilisation mandate and the need to ensure safety and security, SAMA emphasises high quality, high-grade investments and has an overweight position in sovereign bonds. SAMA's asset are well diversified across asset classes, currencies and geographies.

After the 2008 global financial crisis, SAMA's investment patterns have remained largely unchanged. It has maintained its conservative stance of a high exposure to fixed income, SAMA has not engaged with any direct investments, exotic financial products or real estate.

External mandates

SAMA uses both internal and external mandates. For its equity portfolio, SAMA uses external managers. For fixed income, it mostly remains in-house.

Singapore:
Temasek

▶ Key features

- Temasek Holdings is a private investment company, wholly owned but not controlled by the Minister of Finance on behalf of the government of Singapore as sole shareholder;
- It does not identify itself as an SWF, but is often classified as one; in particular as a development fund since it has an objective beyond pure return on investment and has been mandated to invest strategically to develop certain sectors. Peers include Khazanah Nasional (Malaysia); Qatar Investment Authority and Mubadala (UAE);
- Temasek Holdings takes long-term stakes in local and foreign companies, investing mainly in equities in the Asia-Pacific with 82% of its 2014 portfolio held in Australasia;
- Temasek is one of four sovereign investment entities within Singapore's public finance architecture alongside the Monetary Authority of Singapore (MAS) which manages foreign exchange reserves; the Central Provident Fund (CPF) which holds public sector pensions; and the Government Investment Corporation (GIC), which is a higher-return- seeking SWF, managing a portion of excess reserves. Temasek has the highest risk appetite of these sovereign investment entities;
- Since the 2007 global financial crisis, Temasek has defensively pursued greater geographic and sector diversification, moving outside its usual Asian markets into emerging markets and partially retreating from the financial sector in favour of infrastructure, telecommunications, consumer goods and commodity assets;
- Temasek displays relatively unique institutional and governance arrangements. The fund is a government-owned company, directed by its own Board and self-financing through portfolio company dividends, divestments, debt issuance and investment earnings distributions. Its past reserves are constitutionally protected;
- The company contributes to the Government's budget through taxes on profit and by paying an annual discretionary dividend.

Fund snapshot

Year Established	1974	
Assets Under Management	$177 billion (S$223 billion)	
Source of Funds	Privatisation proceeds	
Portfolio at a glance (as at Mar 2014)	Asia ex-Singapore	41%
	Singapore	31%
	Australia and New Zealand	10%
	North America and Europe	14%
	Latin America, Africa, Central Asia and Middle East	4%

I. Background: Economic and political context

Following independence from the British in 1964, Singapore lacked capital, infrastructure and job opportunities. In the absence of raw natural resources, the newly independent state commenced an aggressive industrialisation and economic development programme. To this end, the government acquired minority stakes and established start-ups in strategic sectors such as transportation, industrials, engineering and logistics to foster self-sufficiency and attract private investment[1]. The new government also inherited ownership of several established companies from the British, in aviation, telecommunication and defence sectors[2].

Temasek was established 10 years into this economic development programme to relieve finance and trade and industry ministries from the commercial management of these government-linked companies (GLCs), in which the state had a controlling stake.

1974-1997: Facilitating state-led industrialisation

In the first two decades of its existence, Temasek was a domestically-focused holding company, committed to stewarding its portfolio of GLCs. Temasek took a hands-on approach, appointing civil servants and former politicians to see through the broad economic policy objectives that the state and Temasek had identified for these companies.

The late 1970s saw Temasek adopt a more outward-looking approach, encouraging its GLCs to expand throughout the Pacific Rim and into the recently opened Chinese market, as well as to pursue mergers and acquisitions to become more internationally competitive.

During the early 1990s, as the Singaporean government further liberalised the local economy, Temasek acquired several major public service providers in broadcasting, utilities and electricity, overseeing their privatisation as part of the government's policy to increase competition.

Before the Asian financial crisis of 1997, Temasek's role in the government's state-led industrialisation policy was considered a success. GLCs helped create jobs and Temasek-affiliated firms were some of the most successful, in terms of a credit rating, in Asia. However, critics were concerned about the special treatment received by GLCs, that crowded out private investment.

2002: Going global – the post-Asian crisis revamp

As the Singaporean economy struggled to kick-start after the Asian currency crisis, Temasek was seen as symbolic of the embattled state-centric approach to economic development. The fund needed a revamp. The well connected, high profile business leader Ho Ching, daughter-in-law to Singapore's founding president, Lee Kuan Yew, was appointed Chief Executive Officer.

In 2002 the first Temasek Charter was published, outlining a new strategic vision. The charter specified that the company would expand its focus beyond the competitiveness of domestic portfolio companies to a more global outlook, pursuing foreign investments. Increasingly, Temasek took large stakes in global players in aviation, financial services, healthcare and telecommunications. Additional funding was required for this aggressive new purchasing. However, no new government contributions were forthcoming and divestments were proceeding too slowly. In response, Temasek identified two new funding sources: (1) private debt markets and (2) reserves.

In 2004, Temasek released its first Annual Report to help gain a credit rating to issue bonds, which it commenced in 2005. On the reserves side, the government passed a new rule in April 2004 allowing the transfer of reserves to statutory agencies and the transfer of funds between them. Temasek was allowed access to these resources as long as they accounted for any access attempts to the President.

Aggressive new moves were made into the telecommunications sector with a $2.5 billion investment in Thai telecommunications company Shincorp, and into the West's banking sector through a $2 billion stake in Barclays. As the credit crisis of 2007 set in, Temasek looked to capitalise on distressed assets, taking a $4.4 billion stake in US bank Merrill Lynch at the height of the subprime mortgage crisis.

1. 'The Sixties', Economic Development Board, http://www.edb.gov.sg/content/edb/en/why-singapore/about-singapore/ourhistory/1960s.html.
2. For instance, Malaysia-Singapore Airlines, Singapore Telephone Board.

2008-today: The post global crisis revamp

As the global crisis worsened and Temasek's banking assets continued to falter, the fund defensively exited its mistimed investments after only a year, posting a more than $4 billion loss on Merrill Lynch (now Bank of America) and a $0.5 billion loss on Barclays. The fund also divested from multiple Asian financial services holdings.

In 2009, following the fund's worst ever return of -31%, Temasek announced the departure of Ho Ching and the appointment of a new, chief executive officer Charles 'Chip' Goodyear, former CEO of mining giant BHP Billiton. The move was seen as an attempt to improve the company's independence and integrity, shift the focus away from financials that Ching had encouraged and onto Goodyear's speciality: commodities. But only five months into the handover process, Temasek announced that due to 'unresolvable strategic differences', Goodyear would no longer take over and Ho Ching would remain as Chief Executive Officer.

A revised Temasek Charter was released in 2009, emphasising the company's commitment to becoming a fully commercial investor and no longer simply a vehicle for pursuing government economic policy. Commodities assumed a far greater profile, perhaps reflecting Goodyear's legacy.

Despite some challenging direct investments, the broader effort to globalise the Temasek portfolio has been successful. The company's Asia (ex Singapore) exposure multiplied six times in the past decade, while its exposure outside Asia doubled. Temasek's underlying exposure to Singapore assets is still up S$22 billion from a decade ago, but it now only constitutes 31% of the total portfolio.

Today: Singapore and Temasek

Temasek is still a government holding company that acts as a shareholder on behalf of the Singaporean government. It pursues its developmental mandate by buying direct stakes, mostly in Singaporean and Asian companies, and then reinvesting its proceeds from asset sales and dividend income into foreign assets, acting like a private equity fund. It is, primarily, a concentrated Asian equities investor with 71% allocated to assets in Singapore and Asia, making it one of the least diversified sovereign funds globally.

Singapore is a partial democracy with a written supreme constitution and an elected president who is, ideally, politically independent of government and is entrusted with some oversight powers in relation to certain fiscal matters, including Temasek (eg. drawing down of past reserves and public service appointments). Although Singapore operates its 'two-key' system (discussed in detail later), which protects Temasek's past reserves, the city-state lacks a viable opposition party and culture of political debate and democratic participation. Despite this, Temasek is a relatively transparent and accountable institution, disclosing sufficient information to allow robust popular debate over the company's worrying underperformance during the financial crisis.

II. Official mandate(s)

Just as Temasek's mission continues to evolve, in response to the changing economic needs of Singapore, so too have the fund's institutional and investment mandates. Today, the dominant purpose of the fund is still partially influenced by its original developmental mission – to assist state-led industrialisation through fostering national champions and supporting regional economic development. But it has reinterpreted that mission more broadly to require the pursuit of economic diversification through strategic investment in Singapore and abroad, as well as the delivery of long-term financial returns for the government.

To realise that mission, the fund's **institutional mandate** is 'to create and deliver sustainable long-term returns', and 'focus as an active investor and as an active shareholder on successful enterprises'[3].

Temasek's specific **investment mandate** is to 'deliver value over the long-term'[4]. This mandate is relatively vague, compared to other sovereign investment entities. 'Value' is understood as any return delivered above the cost of capital and value-creation could take several forms, from helping to build local businesses through private equity style investments to a more passive shareholder addition of value[5].

3. Temasek Charter 2009
4. Meeting with Temasek personnel, 31 Jan 2014, Singapore.
5. Meeting with Temasek personnel, 31 Jan 2014, Singapore

The performance benchmark for the fund is Total Shareholder Return (TSR) – compounded annual returns to the government[6], excluding any capital injections from the government. This is measured against 'risk-adjusted cost of capital hurdles'[7]. Over its lifetime, the average risk-adjusted hurdle rates have hovered around 8% to 9%[8].

III. Source of funding

Temasek is unusual, relative to peer sovereign investors, when it comes to funding. Based on its seed capital, the company defies easy classification as a commodity savings or foreign exchange reserves-based fund. Rather, it is better characterised as a privatisation proceeds fund, given its initial seeding in 1974 with a portfolio of 35 GLCs, most of which were subsequently sold off or listed. The transfer of additional privatisation proceeds in the 1990s, with earnings from the government's liberalisation of basic telecommunications, power and port services provision, supports this characterisation of Temasek's funding source. Other privatisation-financed funds include Australia's Future Fund.

In terms of current funding, there is no formal rule-based approach to Temasek's financing. Instead, Temasek is largely self-financing, although it has received occasional capital injections from the government. It has grown its initial portfolio from S$354 million to today's holdings of S$223 billion through three main sources: portfolio company dividends, divestment proceeds and distributions of fund investment earnings.

The last of these is determined in consultation with the government on an annual basis. Each financial year, Temasek's Board recommends a dividend figure to the government. The suggested figure balances the government's need as sole shareholder to receive some dividend, with Temasek's need to retain a proportion of fund returns for reinvestment[9].

In 2005, Temasek added two new funding sources through long and short debt issuance programmes, following the company's inaugural credit rating in 2004. Since then, the company has issued 13 medium-term bonds in US dollars, Singapore dollars and pound sterling, totalling S$11.7 billion and with a weighted average maturity of 14+ years[10]. The use of debt instruments by Temasek places the fund in a niche club of sovereign investors. Abu Dhabi's Invest AD, Bahrain's Mumtalakat and Malaysia's Khazanah Nasional, have all issued bonds to generate capital.

Temasek also has S$1.6 billion in short term borrowings, most of which are Euro-commercial paper (S$1.3 billion)[11]. In total then, Temasek relies on five sources of self-finance:

01. Dividends from portfolio companies;

02. Divestments;

03. Annual distribution of fund earnings;

04. Bond issuance (since 2005);

05. European commercial paper and other short-term debt issuance (since 2005).

Apart from the two discretionary injections of privatisation proceeds, first as start capital and then again in the 1990s, the company has received only the occasional asset injection from the government. For instance, over the past 10 years, there have only been three transfers: in the 2007-2008 financial year, the Ministry of Finance pumped S$10 billion into the company; in 2011, the government transferred a further undisclosed amount to fund the joint venture between Temasek and Khazanah Nasional; and, in 2013, Temasek received a net fresh capital injection of almost S$5 billion from the government. The government subsequently revealed that this funding came from proceeds from the Singapore Government Securities (SGS) – bonds that the government issues to develop the domestic debt market, government land sales in Singapore and government budget surpluses.

6. Temasek Review 2013, p. 19.
7. Temasek Review 2013, p. 2.
8. http://www.temasekreview.com.sg/en/investor/total-shareholder-return.html
9. Temasek Review 2013, p. 52
10. Temasek Review 2013, p. 30
11. Temasek Review 2013, p. 30

The company also receives **indirect** discretionary capital transfers from the government insofar as the government must approve the Board's proposed annual dividend figure, which is typically calculated to allow Temasek to retain some fund earnings for reinvestment.

IV. Liabilities

Unlike most other sovereign funds that manage public assets on behalf of their government-owner in a client-provider relationship, Temasek owns and commercially manages its assets with 'full commercial discretion'. Its explicit liabilities are those faced by entities incorporated under the Singapore Companies Act: corporate tax and an annual dividend owed to shareholders – in Temasek's case, the government.

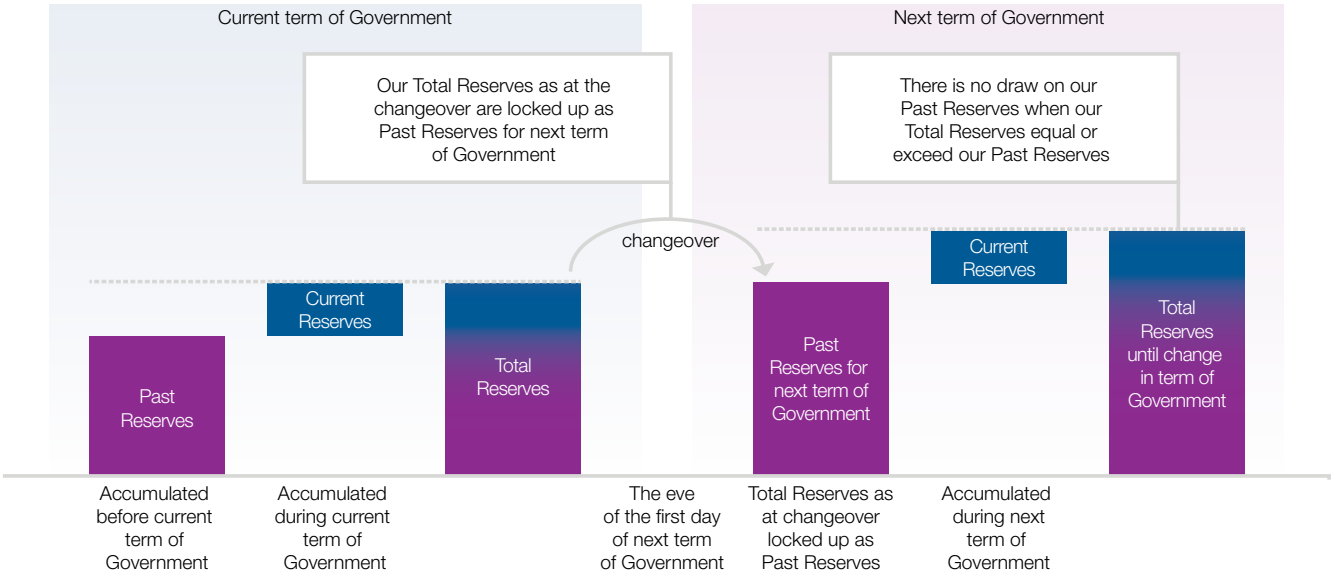
As discussed above, the dividend amount is determined on an annual basis by the Tamasek Board, which makes a recommendation to the government shareholder regarding an appropriate declaration amount at the annual general meeting. The government makes the final decision on the dividend; however, it is capped as to how much it can suggest, as per Article 122 of Temasek's Articles of Association, which stipulates that dividends declared by the shareholder cannot exceed the amount recommended by the Board.

The dividend amount is also governed by a spending rule known as the Net Investment Return Contribution (NIRC) which governs the use of investment income in both Temasek and GIC. This requires that at least half of the investment income derived from past reserves must be locked away for future generations. The Singapore government may use the balance of this income for its budget spending, effectively sharing returns between present and future generations.

Drawdowns

In contrast, drawdowns on the fund are rule-governed. Temasek's past reserves are constitutionally protected from withdrawals as it is a Fifth Schedule entity (a list of key statutory Boards and government companies whose reserves are protected from misuse by the constitution). As shown in Figure 1, past reserves are defined as those accumulated by Temasek **before** the current term of government, while current reserves are those accumulated by Temasek **during** the current term of government.

Figure 1: Governance of Temasek's past reserves



Current governments may only draw down on reserves built up during their term, except in special circumstances. These circumstances are governed by what has been termed Singapore's 'two-key system' of protecting past reserves[12]. The government and the President of Singapore each possess 'keys' that can unlock the reserves, but only if they both agree to turn their keys simultaneously, if conditions at the time warrant such a decision. The unlocking may occur if the government applies to the president as guardian of the reserves to allow access to reserves for budget or policy needs. Only the government is allowed to make such a proposal, and only the president is allowed to review and approve the application. The effectiveness of this safeguard relies on the president's independence from the government. This independence is encouraged by several mechanisms, including the president's direct election by the people, a ban on the president being a politician or a member of a political party or from holding any government jobs at the time of election and during his tenure as president. A statement of reserves and statement of past reserves are presented to the President at prescribed intervals by Temasek's Chairman and Chief Executive Officer as part of the fund's responsibility to protect past reserves.

V. Governance structure

Temasek's governance model is novel – in terms of its two-prong oversight by the Singapore president and the Singapore government, and its governance framework, which contains the best practices of an international holding company, but is clearly enmeshed in the political establishment of Singapore. Several of Temasek's current and former Board members are from the political elite, including the former Chairman, Suppiah Dhanabalan, a former cabinet member from 1978-1994 who retired as Chairman in 2013; the chief executive officer and executive Director Ho Ching, wife of Singapore's current prime minister; Director Lim Boon Heng, a former cabinet member from 1993-2011; and Director Teo Ming Kian, former permanent secretary in various government ministries and executive Chairman in key agencies.

External governance

i. Saving and spending rules

Temasek is partially connected to the broader management of Singapore's public finances. While not formally integrated into the budget process – there are no rules mandating regular transfers of assets to and from Temasek to the government – the company does contribute to the government budget on a yearly basis, through tax on its profits and the annual dividend paid to the government shareholder. As noted above, the dividend amount is not fixed and is instead determined by negotiation between the Temasek Board and government. Similarly, capital injections to Temasek do occur, but they are ad hoc and have occurred only occasionally in its 40-year existence (see our section on Sources of Funding). Past reserves are protected from drawdowns.

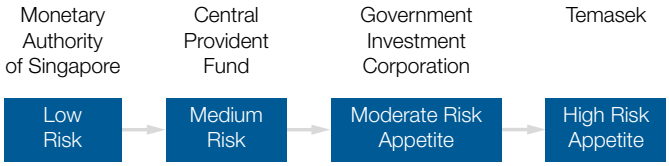
ii. Placement and reporting lines within the public sector

Temasek is a private, commercially run investment company that owns the assets it manages. Neither the president nor the government, as shareholder, can influence Temasek's investment decision-making in a formal sense. That said, the fact that the incumbent chief executive officer of Temasek Holdings, Ho Ching, is the wife of Singapore's prime minister and the daughter-in-law of Singapore's founding president, Lee Kuan Yew, raises questions about the extent of Temasek's apolitical nature.

Temasek is also separate to the other key sovereign investment entities of the city-state. These include the MAS, the CPF and the GIC. Each has its own discrete funding source and its own Board, which is directly accountable to the government for the management of past reserves. Temasek does not manage any funds for these organisations, government surpluses or foreign exchange reserves. The only sense in which Temasek has a relationship to these organisations is that they all have a specific position, relative to one another, on the overarching risk spectrum, which governs the management of Singapore's public financial assets (see Figure 2 below). They also all form part of the Reserves Management Framework as Fifth Schedule entities, so their assets can be tapped by other organisations within the framework, but only through the 'two-key' system. The Temasek Board and chief executive must report to the president every six months on the level of past and current reserves.

12. Clark, G., Dixon, A. and Monk, A. (2013). Sovereign Wealth Funds: Legitimacy, Governance, and Global Power, Princeton University Press.

Figure 2: Risk Spectrum



iii. Transparency and disclosure

Relative to GIC, Temasek is particularly transparent. Both funds are exempt private companies under the Singapore Companies Act, meaning neither entity is required to publicly disclose their audited accounts or financial information. While GIC has embraced this reduced obligation to disclose, refusing to reveal its specific fund and investment size, Temasek has taken a more transparent approach. It releases audited annual reports that disclose its annual returns, value of the whole portfolio on a one-year, two-year, three-year, five-year, ten-year and thirty-year basis – both by market value as well as shareholder funds – full income statements and balance sheets audited by external auditors in accordance with Singapore Standard on Auditing SSA 800.

Internal governance

iv. Institutional governance

Temasek's primary governance mechanism is its 12-member Board, which is set to increase to 13 members in June 2015. The Board is responsible for providing strategic guidance and policy direction to Temasek's management.
The Board determines:

- Overall long-term strategic objectives;
- Annual budget;
- Major investment and divestment proposals above a threshold;
- Major funding proposals;
- Chief executive appointment and succession planning;
- Board changes.

The fact that the Board appoints or removes the chief executive officer, subject to the president's approval, has attracted criticism, as seen with the reversal of the appointment of Charles 'Chip' Goodyear in 2009.

Overall, the Temasek Board consists of mostly non-executive independent business leaders – a strategy to help ensure its independence from excessive government influence (See Table 1). However, under the Companies Act, the government as shareholder, has a right to appoint, reappoint or remove Board members, including the chief executive officer, meaning the Board is not properly insulated from potential political interference. While such decisions are subject to the president's concurrence, this is only a minor safeguard against politicisation, with a number of Board members having strong links to the Singaporean political establishment. That said, recent changes to the Board have increased the overall number of independent private sector business leaders from Singapore or abroad and reduced the number of Directors with a high-level government background. As Table 1 suggests, three of the current 12 Directors have strong links to the government, including the current chair of the Board and the Chief Executive Officer.

In 2013, Temasek's long-time Chairman S Dhanabalan retired and joined the Board of Singaporean SWF peer GIC.

The Board meets at least quarterly and more where necessary. It takes decision by a simple majority vote, including via telephone or video-conference. The Chairman has a casting (second) vote where the vote is tied.

Three Committees assist the Board in carrying out its responsibilities, each of which is chaired by a non-executive Director who is independent from management:

– Executive Committee;

– Audit Committee;

– Leadership development and compensation Committee.

Executive Committee (ExCo)

The ExCo has been delegated the authority to approve new investment and divestment decisions up to a defined threshold, beyond which, transactions will be considered by the Board. The minutes of ExCo meetings are circulated to the Board. In 2013, it met eight times.

Audit Committee (AC)

The role of the AC is to support the Board in its oversight responsibilities by reviewing, among other things, the system of internal controls, and processes used for financial reporting, audit, and monitoring compliance with laws and regulations. Promisingly, the AC is only comprised of independent Directors. The AC also reviews the scope and results of the external audit, and the independence of the external auditors.

Leadership Development and Compensation Committee (LDCC)

The LDCC is responsible for recommending Board and management leadership plans to the Temasek Board. This includes Board and CEO succession, as well as guidelines and policies on performance measurement and compensation plans. Lim Boon Heng, the Board Chairman also chairs this Committee. The LDCC met three times in 2013.

Table 1: Temasek's Board of Directors (as at November 2014)

NAME	ROLE	SELECTED AFFILIATIONS
Lim Boon Heng	Chairman	*Held several Cabinet positions in the Singaporean Government from 1993-2011*
Cheng Wai Keung	Deputy Chairman	Chairman and Managing Director: Wing TaiHoldings Limited
Goh Yew Lin	Member	Managing Director and Group CEO: ComfortDelGro Corporation Limited; Deputy Chairman, SBS Transit Ltd; Deputy Chairman: VICOM Ltd
	Member	Managing Director: GK Goh Holdings Limited Chairman: SeaTown Holdings Pte Ltd, Yong Siew Toh Conservatory of Music
Ho Ching	ED & CEO	Executive Director since May 2002; CEO since January 2004; Former President and CEO Singapore Technologies Group *Wife of the Prime Minister*
Michael Lien JL	Member	Executive Chairman: Wah Hin & Co Pte Ltd Founder: Leap Philanthropy
Teo Ming Kian	Member	Chairman: – MediaCorp Pte Ltd – Vertex Venture Holdings Ltd – Temasek Life Sciences Laboratory Limited – FF Canvac Pte Ltd *Former Permanent Secretary at various Singapore Government ministries and Executive Chairman in key agencies*

NAME	ROLE	SELECTED AFFILIATIONS
Marcus Wallenberg	Member	Chairman – Skandinaviska Enskilda Banken – SAAB AB – Foundation Asset Management Sweden AB
Lucien Wong YK	Member	Chairman and Senior Partner: Allen & Gledhill LLP Chairman: Maritime and Port Authority of Singapore
Robert B Zoellick	Member	Chairman: Goldman Sachs International Advisors Former President: World Bank (2007-2012)
Bobby Chin YC	Member (June 2014)	Member: Council of Presidential Advisers Deputy Chairman NTUC Enterprise Co-operative Associate Member: The Institute of Chartered Accountants, England & Wales
Robert Ng CS	Member (June 2014)	Chairman: Sino Land Company Limited Vice Chairman: M+S Pte Ltd
Peter R Voser	Member (in June 2015)	Chairman: Catalyst; Board of Trustees of St. Gallen Foundation for International Studies Director: Roche Holdings Limited Former Chief Executive Officer: Royal Dutch Shell

Source: Author adapted from Temasek Annual Review 2014
Italicised text highlighting strong links to government

v. Investment and risk management process

The investment process is governed by the Executive Committee (ExCo), which consists of four Board members including the Board Chairman, Lim Boon Heng, who also chairs ExCo.

ExCo may approve new investment and divestment decisions up to a defined threshold, beyond which the Board considers the transaction.

Three Committees assist ExCo and the Board in their investment strategy decision-making:

– Strategy, portfolio and risk Committee: Reviews macroeconomic, global, political and technological context for decision-making;

– Senior divestment and Investment Committee: Reviews, monitors and manages the overall investment portfolio on an on-going basis;

– Senior Management Committee: Sets overall management policies.

Temasek's investment strategy is set out in the Temasek Charter, first devised in 2002 under Ho Ching's leadership and revised and updated in 2009. Prior to 2002, Temasek's investments were less speculative and largely situated in Singapore, with most holdings in companies that owned or provided critical resources or services. The 2002 Charter moved the fund away from that approach, 're-affirm[ing] the role of Temasek as a commercial investment company to create and deliver sustainable long-term returns'. The revised 2009 Charter re-emphasised the company's commercial, contra-strategic objectives and made a new commitment to be an active investor.

VI. Investment style and strategy

Under Temasek's mandate to create and deliver 'sustainable long-term returns for stakeholders', is a long horizon investor that operates according to the distinct philosophy of 'patient capital'. Returns are measured as Total Shareholder Return over distinct long-term horizons including 10, 20 and 30 year periods since inception, relieving Temasek of the pressure felt by many sovereign investors to divest during difficult economic times.

Although there are no limits or targets for asset classes, geographies or sector exposures, Temasek is primarily a concentrated equities investor with a highly liquid portfolio focused on Asia. As at 2014, 72% of its portfolio was held in liquid, listed assets and 71% of total portfolio assets were in Singapore and Asia.

Temasek's overall portfolio is concentrated in terms of geography and sector. The majority of the listed-equities portfolio sits in financial services and telecommunications, split more or less evenly between 'Group A companies', considered strategic domestic investments with a more than 20% ownership stake, and 'Group B companies', typically foreign businesses in which Temasek holds less than a 20% stake. Overall, Temasek is invested in sectors deemed to benefit the Singaporean economy, such as financial services, technology, media, telecommunications and healthcare. Geographically, most portfolio assets are invested domestically or in Pacific Rim markets. The portfolio has 31% invested in Singapore, with China the second biggest exposure at 23%. This heavy Asian focus has meant that Temasek has invested more in emerging and frontier markets than any other sovereign fund[1].

This is a legacy of Temasek's mission, in the 1980s and 1990s, to help build local and regional champions and is also a product of the recent post-crisis strategy to increase exposure to the Chinese banking sector, following disappointing investments in Merrill Lynch and Barclays in 2007 and 2008.

The financial crisis also forced a broader diversification in investment strategy. After the fund's scarring foray into the Western banking sector, Temasek sought to reduce its exposure to financial services and increase diversity through new asset classes including infrastructure, manufacturing and consumer goods. Since 2009, there has also been a growing interest in commodities, following Charles Goodyear's short stint as incoming Chief Executive Officer, where he had identified commodities and private markets as strategic priorities.

Active investor

Temasek is an active investor that tries to outperform the markets. It invests with the 'expectation of higher returns over the long-term', and accepts a 'higher year to year volatility of returns' in pursuit of this long-term value[2]. For instance, the fund suffered their worst annual Total Shareholder Return of -31% in March 2009 during the financial crisis, but a year later had rebounded to a positive return of 43%.

Temasek is also an active owner of portfolio companies. While it is not involved in the day-to-day operations or commercial decisions of portfolio companies, Temasek does engage investee companies to promote robust governance and foster a strong culture of excellence and integrity, as well as to build sustainable competitive advantages, and maximise long-term shareholder returns.

Direct investor with external mandates

Temasek is primarily a direct equity investor with less than 10% of its portfolio in third party managed funds[3]. Alongside many Canadian public investors, like CPPIB and Ontario Teachers' Pension Plan, well-known for their commitment to reduced reliance on external mandates through improved in-house capabilities, Temasek is one of the world's longest-running and largest direct public investors.

External mandates are mainly used for real estate, private equity, bond, index and hedge funds' investments. Issuance of discretionary mandates to external fund managers is permitted[4].

1. Sovereign Wealth Centre, 'Strategy Forecast', Temasek Profile.
2. Temasek Review 2013, p. 41.
3. Temasek Review 2013, p. 10.
4. Lee p.65.

Singapore: Government Investment Corporation (GIC)

▶ Key Features

- The Government of Singapore Investment Corporation (GIC) is a private company, wholly owned but not controlled by the Ministry of Finance on behalf of the government of Singapore as sole shareholder;
- The Singaporean government and the GIC enjoy a fund manager and client relationship, where the government remains the owner of the funds and pays a fee for services to GIC;
- The GIC is mandated to preserve the international purchasing power of reserve assets;
- Singapore has vast foreign reserves. At the end of2013, Singapore's reserves were the 11th highest in the world at US$273 billion. GIC has managed a portion of Singapore's accumulated reserves since 1981 and is now one of the world's largest sovereign funds;
- GIC is one of four sovereign investment entities within Singapore's public finance architecture alongside the Monetary Authority of Singapore (MAS) managing foreign exchange reserves; the Central Provident Fund (CPF) managing public sector pensions; and Temasek, the government's high-return-seeking investment holding company mandated to fuel domestic development. GIC has the second highest risk appetite of these entities;
- GIC has one of the longest investment horizons in the SWF world with a 20 year real rate of return mandate. It reports annualised returns over a five, ten and 20 year period;
- The fund implemented a new investment framework in 2013, which allocates capital to assets and investment strategies based on opportunity cost.
- In April 2014, GIC opened its 10th overseas office in Sao Paulo, Brazil and created a new position of chief operating officer to improve integration of front and back office functions.

Fund snapshot

Year Established	1981	
Assets Under Management	$315 billion (estimate)	
Source of Funds	Foreign exchange reserves	
Portfolio at a glance (as at Mar 2014)	Developed market equities	29%
	Emerging markets equities	19%
	Nominal bonds and cash	31%
	Inflation-linked bonds	5%
	Real estate	7%
	Private equity	9%

I. Background: Political and economic context

Following independence from the British in 1964, Singapore commenced an aggressive industrialisation and economic development programme, given the absence of raw natural resources, capital, infrastructure and job opportunities. This programme was successful and the newly-independent state began to accumulate vast foreign reserves from large balance of payment surpluses. Then deputy Prime Minister and Chairman of the MAS) Dr Goh Keng Swee, identified the need for an entity dedicated to the task of investing these growing reserves for better long-term returns. This was supported by the country's founding Prime Minister Lee Kuan Yew and the GIC was created in 1981 for the sole purpose of managing Singapore's foreign reserves.

At the time of the GICs establishment, international financial markets were facing a sovereign debt crisis, banking insolvencies, oil price inflation and high US interest rates leading to local inflationary pressure on Singapore's reserves. In response, the GIC was given a two-fold mission:

01. To protect the value of Singapore's domestic savings;

02. To help mitigate inflationary pressure at home through international investment.

The fund had an initial $5 billion allocation of exchange reserves, with the possibility of further capital injections on an annual basis. The initial Board focused on setting up organisational and investment capabilities, despite the inflationary pressures and was subsequently able to capitalise on a later deflationary phase, which helped the value of acquired financial assets in the early portfolio. On Black Monday in October 1987, triggered by a 508-point fall in the Dow Jones Industrial Average, global stock markets tumbled. The market turbulence tested the new fund's asset allocation, demanding a high degree of agility.

1997: The impact of the Asian financial crisis

The importance of the GIC as a preserver and enhancer of domestic wealth grew after the Asian financial crisis of 1997-1998. Singapore, along with most of the Asian region economies, experienced substantial economic contraction with growth slowing from 8.3% in 1997 to -1.4% in 1998 and the Singapore dollar depreciating by roughly 15% relative to the US dollar. At the same time, Singapore rebounded much more quickly than other affected economies, experiencing substantial growth in GDP of 7.2% in 1999 and 10.1% in 2000, outperforming all other countries in the region apart from Korea. It was even able to act as a creditor in the IMF-led recovery programme, promising loans to Thailand and Indonesia.

This experience was formative, both for Singapore and its neighbours, insofar as it vindicated Singapore's early creation of a reserve investment corporation to help build its reserves. The rapid capital outflows experienced during the crisis and the demanding conditionality of the IMF's assistance packages had elevated the importance of stockpiling international reserves as a form of self-insurance against such turbulence. Singapore's speedy resilience and relatively unscathed position, relative to its neighbours, was partly attributed to its huge foreign reserves. The GIC had demonstrated the effectiveness of diversifying excess reserves rather than hoarding reserves in low-risk, low-yielding assets in the central bank, a more costly option.

Today Singapore is a leading advanced economy and the GIC is one of the largest sovereign wealth funds in the world, but the city-state remains mindful of its vulnerabilities, including a lack of raw materials and a dependence on imports. The leadership continues to emphasize GIC's on-going role as a safeguard against unforeseen circumstances and a vehicle to mitigate shocks that might hit Singapore's small, open economy.

II. Official mandate(s)

The GIC's mission is to preserve and enhance the purchasing power of Singapore's foreign reserves. It does so with a view to building up a nest-egg for times when Singapore's export-led, open economy may be severely affected – especially given the country's lack of revenue-producing natural resources.

The institutional mandate of the GIC is to preserve and enhance reserves to help build a safeguard for Singapore against shocks from global financial markets.

The investment mandate of the GIC is to achieve a 'reasonable risk-adjusted rate of return above global inflation over a 20-year investment horizon'.

III. Source of funding

Unlike Temasek, whose capital injections are irregular, GIC is funded by an annual contribution from the government financed by balance of payment surpluses and accumulated national savings. The size of the contribution is at the government's discretion. This also means that GIC's funding has the backing of Singapore's large foreign exchange reserves, while Temasek does not enjoy such backing. The portfolio has also grown as a result of investment returns, as there is a rule capping the amount of returns the government may withdraw from the GIC (see discussion below in Liabilities section).

GIC does not own this injected capital, but, instead, manages these assets on behalf of its client, the government of Singapore. The majority of the government's financial assets, other than deposits with the MAS and the stake in Temasek Holdings, are managed by the GIC.

While the annual capital injections increase the overall portfolio size of the GIC, they are not calculated as part of the fund's investment returns.

The GIC does not disclose its total assets under management (AUM) on the basis that revealing GIC's AUM as well as publishing the assets of MAS and Temasek would amount to publishing the size of Singapore's financial reserves, which the government considers to be against the national interest. The concern about revealing all assets is that speculative attacks may be mounted on the Singapore dollar during periods of volatility.

IV. Liabilities

The GIC's liabilities to the Singapore government is governed by a spending rule. This rule only governs how much of the investment returns on the GIC's net assets the government can spend, since the underlying principal is constitutionally protected. The rule, called the Net Investment Returns Contribution (NIRC), allows up to 50% of the long-term expected real return on the net assets managed by GIC and those owned by the MAS (as opposed to fiscal surpluses the government may transfer) to be taken into the government's annual budget. This contrasts with the spending rule that applies to Temasek, under the NIRC, which allows up to 50% of the investment income from the remaining assets to be transferred to the budget. In 2012, this amounted to about 15% of Singapore's total budget.

The Singapore constitution permits the government to utilise up to 50% of the NIRC contributed to the budget each year, resulting in some portion of the returns being saved for future budgets. The portion that the government uses has typically been allocated to long-term investments in things like education, healthcare, environment and research and development.

Drawdowns

Singapore's constitution protects 'past reserves' to prevent reckless government spending. Past reserves refers to the reserves accumulated during previous terms of government and Fifth Schedule entities, including GIC and Temasek are protected. The reserves of each entity are separately protected for clear accountability.

In 2002 and 2004, amendments to Singapore's constitution were made to allow for the transfer of past reserves between Fifth Schedule entities (MAS, GIC, Temasek, CPF and others) and the government. These amendments did not constitute any loss or drawdown on total past reserves since past reserves were still unable to be transferred outside of the Reserves Protection Framework without the approval of the president. If restructuring of Fifth Schedule entities is required, in order to deliver better public services, then past reserves may need to be transferred to facilitate this.

The constitutional amendments make clear that there is no drawdown on past reserves as long as (i) past reserves are being transferred among entities that are within the Reserves Protection Framework; and (ii) the receiving entity undertakes to protect the past reserves that are transferred over. In such circumstances, the overall amount of past reserves being protected is unchanged, and hence the president's approval need not be obtained for such transfers.

How can a drawdown on past reserves occur? First, if the government or a Fifth Schedule entity spends more than the reserves it has accumulated during the current term of government, a drawdown occurs. Second, a drawdown takes place when an asset is sold below its fair market value and the difference is not topped up from the reserves that were accumulated in the current term of government. An investment loss does not constitute a drawdown on past reserves, as long as the disposal of the investment is done at fair market value.

Just like Temasek, the GIC's past reserves are also protected by the 'two-key' system requiring both the government and the president to agree to tap the reserves (see 'Liabilities' section in Temasek profile for a discussion of the process).

Despite the protection offered by the two-key system, the GIC's reserves were unlocked and tapped during the 2008 global financial crisis, following the first request ever from the government to the president to draw down on reserves to meet budget expenditure. These events revealed ambiguity regarding the legitimate basis for withdrawals from the GIC. Senior minister Goh Chok Tong sought to clarify what would not count as a legitimate drawdown and identified three situations where reserves should not be drawn upon:

01. To support social assistance programmes;

02. To fund permanent government programmes;

03. Any situation that is not a 'dire circumstance' requiring reserves to ward off catastrophe.

Despite this clarification, GIC reserves were used for social welfare during the 2008 global financial crisis, going towards workfare subsidies, job credits and direct assistance to families. While the basis for tapping the reserves is constitutionally enshrined, the protocols around this process need greater clarity for the two-key system to function effectively[1].

V. Governance structure

External governance

i. Savings and spending rules

As noted previously, the GIC has a partly rule-governed approach to its savings and spending. The government saves part of its foreign exchange reserves in the GIC through an annual transfer of balance of payment surpluses and accumulated national savings, but the size of the contribution is at the government's discretion. It is not clear whether the requirement to undertake the annual transfer is enshrined in law or simply a convention. There is a clear rule-based approach regarding the spending of GIC returns, governed by the NIRC programme. This mandates that up to 50% of net investment returns on GIC and MAS net assets must be transferred back to the budget annually (with the actual amount at the discretion of the government). The rules governing ad hoc drawdowns on the past reserves of the GIC are also partly rule-governed with the process for tapping the reserves governed by the Constitution, but the basis for initiating this process lacking formal regulation.

ii. Placement and reporting lines within the public sector

GIC provides monthly and quarterly reports to the Accountant-General of Singapore. These reports list the financial transactions, as well as the holdings and bank account balances. The reports provide detailed performance and risk analytics, as well as the distribution of the portfolio by asset class, country and currency. Once a year, GIC management formally meets the minister of finance and Ministry of Finance officials to report on the risk and performance of the portfolio in the preceding financial year. The fund is also accountable to the president of Singapore who is constitutionally empowered to obtain information from GIC (and other Fifth Schedule entities) to safeguard the country's reserves. The president's agreement is also required for all Board appointments and removals.

1. Clark, G., Dixon, A. and Monk, A. (2013). Sovereign Wealth Funds: Legitimacy, Governance, and Global Power, Princeton University Press.

GIC is one of three sovereign agencies dedicated to the management of Singapore's reserves, along with Temasek and MAS. All three, while independent from one another with their own Boards, are linked through their shared role in managing the country's reserves under the Reserves Protection Framework and protecting past reserves as Fifth Schedule entities.

Their unique roles within the Reserve Protection Framework are best illustrated through a risk spectrum lens. Figure 2 in this section shows how each entity helps diversify risk, while jointly participating in the overall project of managing the country's reserves. MAS is the most conservative, holding mainly liquid financial market instruments; Temasek has a higher risk appetite; and GIC aims to preserve and enhance reserves through a more globally diversified portfolio than MAS. GIC's relationship to Singapore's fourth sovereign investment entity, the CPF, is less clear. GIC has indicated that, since the government of Singapore cannot spend any monies raised from government borrowings and since CPF funds are invested in bonds though the Special Singapore Government Securities programme, the proceeds from these government borrowings may flow into GIC for management. However, this process is not made explicit to the public or to GIC itself.

Figure 1: Risk spectrum of Singapore's reserves management agencies

iii. Transparency and disclosure

Both GIC and Temasek are exempt private companies under the Singapore Companies Act, meaning neither entity is required to publicly disclose their audited accounts or financial information. While GIC has voluntarily issued annual reports since 2008 and uploads updated information to its website from time to time, overall it has embraced a reduced obligation to disclose, refusing to reveal its specific size. In contrast, Temasek has taken a more transparent approach, disclosing its annual returns, value of the whole portfolio on a one-year, two-year, three-year, five-year, ten-year and thirty-year basis, and provides full income statements and balance sheets audited by external auditors. The Auditor-General, who is appointed by the president of Singapore, submits an annual report to the president and parliament of his audit of the government and other bodies managing public funds.

GIC does publish its five year, 10 year and 20 year annualised nominal rates of return, and it's rolling 20-year real rate of return. The 20 year rate of return reflects the government's investment mandate for GIC, which emphasises that it should invest the portfolio with a long-term orientation. The five and 10 year timeframes give an intermediate measure of the ongoing performance of the portfolio. GIC does not provide one year returns as it argues these are too short term, in relation to GIC's 20 year investment horizon. As 20 years is a long period, GIC publishes five year and 10 year nominal rates of returns in US dollar terms to reflect the medium-term investment performance of the portfolio, but not the real rates of return.

GIC's former Chairman, Minister Mentor Lee Kuan Yew, has presented two reasons for GIC's reduced transparency. Firstly, the avoidance of populist pressures and prevention of anticipation of its moves by others. Prior to GIC's first annual report in 2008, GIC was a somewhat uncommunicative organisation, with only glimpses of its investment strategy disclosed in the requisite reporting filings in the relevant foreign jurisdiction. For example, in October 1993, GIC's disclosure of its US investment stakes in Schedule 13D – forms which investors must file when they acquire 5% or more of the public company's equity securities in the USA – revealed its strategy of buying depressed stock.

Secondly, the investment strategies of GIC and Temasek are, to some extent, different from one another. GIC focuses on foreign investment, whereas Temasek makes foreign and domestic investments. Minister Mentor Lee Kuan Yew confirmed the lower risk approach of GIC: 'Temasek will take higher risk for higher returns. GIC, we treat it more as a pension fund and we are prepared to forego the higher returns because we don't want to take those high risks'.

However, the Santiago Principles and founding of the IFSWF of which GIC is a member influenced the fund's behavior. Shortly after the development of the Santiago Principles commenced, GIC issued its first report on its investment strategies and policies (GIC Report 2008). It has since issued annual reports, although due to its non-disclosure of total assets under management, GIC has a relatively low score on a number of international transparency indexes for SWFs.

Internal governance

iv. Institutional governance

Internally, GIC's primary governance mechanism is its 14-member Board, chaired by Singapore's Prime Minister, Lee Hsien Loong. Board members are appointed by the Ministry of Finance, representing the government as owner, with assistance from the GIC in sourcing qualified candidates. Under the constitution, the agreement of the president of Singapore must be sought for the appointment, removal or renewal of Board members. Before the President decides on whether to concur, he obtains advice from the Council of Presidential Advisers (CPA), which, in turn, scrutinises the appointment. The President has discretion to decide whether or not to concur with the appointments after consulting the CPA.

The Board contains multiple members of Singapore's political elite, including the deputy Prime Minister and Minister of Finance, Minister for Trade and Industry, Minister for Education and deputy Prime Minister and Minister for National Security. Founding Prime Minister of Singapore Lee Kuan Yew is a Senior Advisor to the GIC Board. The former Chairman of Temasek, S Dhanabalan, joined the GIC Board in August 2014.

Smaller Boards assist GIC's main Board in managing discrete arms of the business including:

– GIC Asset Management Board of Directors (4 members);

– GIC Real Estate Board of Directors (4 members);

– GIC Special Investment Board of Directors (4 members).

There is also a nine-member International Advisory Board, made up of international business luminaries.

v. Investment and risk management process

The Ministry of Finance, representing the government, sets the investment objective, risk parameters and investment horizon for the portfolio and ensures a competent Board of Directors is in place. Internally, the GIC Board then assumes responsibility for asset allocation policy and overall performance of the portfolio while management is responsible for formulating and executing investment strategies and for individual investments. Investment and risk decisions are made by the Group Executive Committee (GEC), the highest management body in GIC, containing the groups functional and investment heads. It deliberates on management proposals for investment and risk issues before these are submitted to the relevant Board Committees and the GIC Board. The GIC Board will then approve a policy portfolio which specifies the allocation of funds to eligible asset classes. The aim is to optimise distribution of investment funds to the asset classes. The relationship and responsibilities of the GIC's various Committees is set out in Table 1.

The GEC also reviews and approves major business, governance and policy issues of significance to GIC, which apply to the entire group. This process is overseen by three specialist Committees:

01. Investment Board: assists the GIC Board in its oversight of GIC's investment process;

02. Investment strategies Committee: oversees GIC's performance and risk profile and makes appropriate recommendations to the Board on investment policy;

03. Risk Committee: advises the Board on risk matters and focuses on overseeing GIC's risk policies and risk management.

Table 1: GIC governance arrangements

		TERMS OF REFERENCE
GIC Board		Responsible for the GIC's Policy Portfolio which determines its long-term asset allocation strategy and for the overall performance of the portfolio. Does not approve individual investments which are the responsibilities of the management.
International Advisory Board		Provides views on market developments generally and, in particular, the medium to long term outlook for investment opportunities around the world.
Board Committees	Investment Strategies Committee	Assists the GIC Board in evaluating Management's recommendations on asset allocation, and in its oversight of overall portfolio performance. Recommends the key drivers for GIC's return and risk outcomes. Does not approve individual investments.
	Investment Board	Assists the GIC Board in its oversights of GIC's investment process, with particular attention to large individual investments.
	Risk Committee	Oversees the effectiveness of risk management policies and practices in the GIC Group.
	Audit Committee	Looks into the effectiveness of the internal control systems for safeguarding company's assets and client's investment portfolios. Reviews the integrity of the financial reporting process, significant ethics violations, compliance with regulatory and legal requirements, and issues of fraud and financial losses.
	Human Resource and Organisation Committee	Oversees organisational matters in GIC, including compensation policies, talent development, succession planning, and organisational development.
GIC Management		Formulation and executes investment strategies. Constructs Active Portfolio, with an overlay of active, skill-based strategies.

Source: GIC Annual Report 2014

Risk management

GICs approach to risk management was refined with the implementation of a new investment framework in 2013 that introduced a Reference Portfolio, Policy Portfolio and Active Portfolio to assist management in tracking investment performance and managing risk. The Reference Portfolio reflects the Singapore government's risk appetite (and consists of a 65:35 global equity/bonds split), while the GIC Board approves the Policy Portfolio, which is expected to deliver superior returns vis-à-vis the Reference Portfolio over the long term (discussed below in 'Investment Style'). GIC management is given the discretion to add value within a risk budget and stress limit set by the GIC Board through the Active Portfolio which comprises active, skill-based strategies. The Policy and Active Portfolios are constructed with the Singapore government's long-term real return objective and its primary risk reference, an ex-ante stress loss requirement, in mind. The active risk budget is also supplemented by a set of investment guidelines to ensure that the essence of the policy portfolio is preserved and to limit concentration risk. The division of decision-making responsibility under the new Investment Framework is set out in Table 2 below.

Table 2: GIC responsibilities and roles under the investment framework

	RESPONSIBILITY
GIC Board	Approves Policy Portfolio and active risk budget
Investment Strategies Committee	Review GIC management's recommendations on Policy Portfolio and active risk budget
Investment Board	Oversees GIC management's active strategy
GIC Management	Recommends Policy Portfolio and constructs Active Portfolio
Investment Teams	Add value through implementation of Policy Portfolio and active strategies

Source: GIC Annual Report 2014

VI. Investment style and strategy

GIC's objective is to achieve good long-term returns above inflation over a 20-year investment horizon to preserve and enhance the international purchasing power of Singapore's reserves. To this end, the GIC is a fairly conservative investor, with a globally diversified portfolio spread across various asset classes. Most of its investments are in the public markets, in equities and fixed income, with a smaller component in alternative investments such as private equity and real estate.

It subscribes to five investment principles:

01. Pursue intrinsic value and maintain price discipline;

02. Practise long-term investing;

03. Pick key spots: be focused and leverage strengths;

04. Pay attention to risk control;

05. Prepare for the future.

GIC does not have specific geographic or asset class allocations, instead focusing on long-term performance of the total portfolio. However, GIC has indicated that more investment in Asia could be expected over the long term, even though there is no target.

In 2013, GIC established a new investment framework to help respond to the challenges of the global investment climate. Under this framework, GIC distinguishes between three drivers of long-term performance. The first is the performance of global markets, represented by the Reference Portfolio. This portfolio comprises 65% global equities and 35% global bonds and reflects the Singapore government's risk and return expectations. The second is GIC's strategy for asset allocation represented by the Policy Portfolio, which aims to achieve returns superior to the Reference Portfolio over the long term. The Policy Portfolio is approved by the GIC Board, and comprises six asset classes:

01. Developed market equities;

02. Emerging market equities;

03. Nominal bonds and cash;

04. Inflation-linked bonds;

05. Private equity;

06. Real estate.

The third driver, active investment strategies, as embodied by the Active Portfolio, seeks to outperform the Policy Portfolio, within risk limits that are set by the GIC Board. These strategies involve selecting investment opportunities within each asset class, as well as investing in asset classes that are not contained in the Policy Portfolio and in cross-asset class strategies. The GIC management is allowed to deviate from the Policy Portfolio and add value through active, skill-based strategies.

In its 2014 annual report, GIC reported five, 10 and 20 year annualised nominal returns in US dollar terms of 12.4%, 7.0% and 6.5% respectively. It also reported a 20 year real rate of return of 4.1%. The rolling 20 year real rate of return is the primary metric for the government to evaluate GIC's investment performance.

Active investor with external mandates

The use of external fund managers varies considerably from asset class to asset class. External fund managers are given discretionary mandates in a wide range of asset classes, such as global fixed income and global equities. For public markets, external managers manage up to 20% of the public markets portfolio. For the funds under external management, GIC adopts an active investing approach, under which investment managers seek to outperform public market benchmark indices, rather than just matching their performance, as in passive investing.

For alternatives such as real estate, GIC manages most of its investments itself. In the case of private equity, GIC has a network of over 100 active fund managers.

South Africa: Public Investment Corporation

▶ Key features

- The Public Investment Corporation (PIC) is the largest fund manager on the African continent with US$165 billion under management. Within South Africa, it is the only investment fund focused exclusively on the public sector, managing capital on behalf of 23 public bodies;
- This capital is predominantly public pension money from the PIC's largest client, the Government Employees Pension Fund (GEPF) which supplies almost 90% of its funding;
- The fund has a dual mandate to deliver investment returns for its public sector clients and to contribute to the development of South Africa;
- For most of its 103 year investment life, the PIC has been restricted to domestic investments, but, in 2010, its mandate was changed to allow 10% of the portfolio to be invested in foreign markets. Half of this, roughly $7.5 billion, is earmarked for investments in sub-Saharan Africa with the other half directed towards global equities;
- Given its predominant focus on managing public pension capital, the PIC considers its peer funds to be CalPERS (US), Queensland Investment Corporation (Australia), Canadian Pension Plan Investment Board, Namibian Government Institutions Pension Fund, Zambian National Pension Scheme Authority and the Nigerian Social Insurance Trust Fund;
- In terms of its ownership arrangements and institutional design, however, it is more similar to development oriented sovereign funds, such as Singapore's Temasek. Like Temasek, the PIC is an incorporated entity, and it is wholly owned by the South African government, represented by the minister of finance as shareholder, to whom the PIC pays discretionary dividends;
- The PIC manages the majority of its assets in-house, outsourcing just 25% of its equities portfolio to external managers.

Fund snapshot

Year Established	1911	
Assets Under Management (as at March 2014)	$165billion (R1.6 trillion)	
Source of Funds	Public sector funds of 23 public bodies	
Portfolio at a glance	Equities (local, Offshore and Africa ex SA)	53.25%
	Bonds (local and offshore)	36.81%
	Cash & Money Market	7.12%
	Properties	4.39%

I. Background: Economic and political context

The PIC's predecessor, the Public Debt Commissioners (PDC) was established in 1911, two years after the Union of South Africa. It was set up as part of the British colonial government's reconstruction effort following the Boer Wars. The PDC's mission was to manage trust funds in the government's care and its mandate was restricted primarily to debt management.

During its first 40 years, the PDC's clients included South African Railways and Harbours as well as the public funds of provincial administrators. By 1951, forty years after establishment, the organisation managed £106.4 million in total assets, a vast sum at that time.

In 1961, South Africa became a Republic following a referendum and established its own currency, the rand. By this time, total PDC assets totalled 1.6 billion rand. The PDC was renamed the Public Investment Commissioners, signalling a shift in the organisation's focus, from debt management to return-seeking investment. The organisation began to invest public funds on behalf of its government sector clients. During this decade, South Africa's economic growth was rapid, peaking at 8.9% in 1965. This resulted in a substantial allocation of public funds to the PIC.

During the 1980s, social change was gripping the country as the apartheid regime faced collapse. Economic growth faltered, dipping to 2.1%. The PIC formed the Isibaya Fund, dedicated to domestic investments aimed at fuelling the socioeconomic development of South Africa.

1994-1999: End of apartheid and transition to democracy

Political transition brought hope for new economic opportunities within South Africa. The PIC looked to diversify and capitalise on these changes, moving into property investments, both directly and indirectly held, and established the Isibaya Fund, used to support development-related investments. Isibaya's main focus was to provide finance to commercially viable projects based in South Africa, with a strong social and economic impact at both the micro and macro levels.

2004: Corporatisation of the PIC entity

Today's PIC was created through the Public Investment Corporation Act 2004. With the Act's promulgation on 1 April 2005, the PIC transformed from a bureaucratic entity, governed by public sector rules, to a corporation – allowing it to become a competitive, independent, private-sector style asset manager.

The corporatisation move had several advantages. Firstly, the PIC qualified for registration with the Financial Services Board, which required financial services providers to operate under detailed client investment mandates, encouraging a more transparent and competitive asset management approach. Secondly, the organisation gained autonomy to recruit and compensate talent, in line with market rates, building the foundation for a more sophisticated investment capability. Thirdly, on becoming a corporation, the PIC's Board of Directors gained full responsibility for all employment matters, including performance management, improving the Directors' ability to ensure optimum performance. Finally, the fund enjoyed greater independence from the government, moving from an owner-manager to a client-shareholder relationship. This was given effect through the creation of a Board with a majority of non-executive Directors, allowing greater independence from the government and senior management.

2007-2010: Navigating the global financial crisis

Despite the organisational benefits of corporatisation, the PIC faced some tough years as it rolled out its new private sector form – in particular, the financial crisis in 2007. South Africa's economic growth slowed massively, dipping to 1.8% in 2009. Despite some headline investment opportunities – including the development of airport and tourist infrastructure for the 2010 world soccer tournament – the PIC's domestic-only investment mandate combined with economic stagnancy in South Africa, caused problems. The organisation had vast holdings, but faced a lack of sizeable investment opportunities in South Africa.

2010-2014: Reorientation of the PIC portfolio – globalisation, long-term and developmental

During these years, the PIC adopted the development investment policy of its major client, the GEPF, which called for investments that contributed positively to the development of the South African economy and that improve the livelihoods of South Africans. The PIC also developed a ten year strategy around the new vision of its role in society.

In 2011, the PIC's investment mandate was changed to allow 10% of the portfolio to be invested abroad. Half of this was to be invested in the rest of the African continent outside of South Africa and the other half in global bonds and equities. The mandate change was driven by two factors:

01. The geographical over-concentration of the PIC's assets left it vulnerable in terms of risk diversification;

02. The fund's long-term objective to be a 'good neighbour' within its development mandate and help develop a unitary economy on the continent.

Deployment of this capital has been slow. As at 2013, only 1.5% of the 5% earmarked for investment in Africa was invested. This is partly due to price distortion concerns. The $7.5 billion ($60 billion rand) reserved for investment in Africa is almost double the existing private equity market on the entire continent. There are also concerns about currency risk given the 54 different currencies in circulation within the continent. Initially, there will be a preference for pricing investments in US dollars and for pursuing co-investments with Africa-based partners. That said, the PIC closed its first African investment through its acquisition of a stake in Ecobank, providing the PIC access to over 30 countries. Furthermore, two funds have been established to meet the Africa investment target of 5% of assets under management: the Africa Developmental Investments and Private Equity Africa, with each helping to allocate a minimum commitment of up to $500 million in the 2014/2015 financial year.

II. Official mandate(s)

The PIC's mission is very broad. It's founding Act, the Public Investment Corporation Act 2004 stipulates that the organisation is 'to provide for the investment… of certain monies received or held by, for or on behalf of the Government of the Republic and certain bodies, councils, funds and accounts'. Essentially, the PIC's core purpose is to be the investment arm of the government of South Africa, providing non-banking financial services to public bodies.

To realise that mission, the fund has a four-fold institutional mandate:

01. Deliver investment returns in line with client mandates;

02. Create a working environment that will ensure the best skills are attracted and retained;

03. Be a beacon of good corporate governance;

04. Contribute positively to South Africa's economic development.

Of these, the PIC considers its primary responsibility to deliver financial returns that meet and, ideally, exceed client mandates. That said, PIC Management is quick to emphasise that its development mandate is compatible with its investment return mandate, highlighting multiple investments that make good business sense, as well as contribute to socioeconomic transformation, such as its property investments in township developments.

The PIC has different investment mandates from its 23 public sector clients who individually negotiate their mandate in accordance with their own investment objectives and risk appetite. Each mandate sets out the desired asset allocation, benchmarks, risk parameters, expected returns, reporting requirements and management fees.

Given the dominant role of the GEPF, the PIC's largest client supplying 90% of the fund's portfolio (see below), the GEPF investment mandate heavily influences the PIC's overall investment behaviour. The current GEPF mandate requires up to 10% of the equities fund be invested outside of South Africa, with 5% in offshore equities and the remaining 5% to be invested in the rest of the Africa continent. The performance benchmark for the GEPF is 3% above inflation.

III. Source of funding

The PIC's seed funding is public capital entrusted to it by various bodies within the South African public sector that operate pension, provident, social security and guardian funds. Some of these public clients are required by their founding legislation to invest through the PIC, while others are not. An additional funding source is the management fee paid by clients for PIC services, although this is typically lower than prevailing market rates and is negotiated with each client individually.

At present, the PIC has 23 public bodies as clients. The largest of these is the GEPF, South Africa's biggest pension fund, which accounts for almost 90% of the PIC's assets. Other PIC clients are set out in Table 1 below.

Table 1: Breakdown of PIC funding sources

CLIENT	% OF AUM
Government Employee Pension Fund (GEPF)	89.34%
Unemployment Insurance Fund (UIF)	5.84%
Compensation C ommissioner Fund (CC)	1.63%
Compensation Commissioner: Pension Fund (CC: PF)	0.95%
Associated Institutions Pension Fund (AIPF)	0.87%
Other*	1.37%

Source: PIC website
*Constitutes various clients with smaller portfolios

IV. Liabilities

All assets under management belong to the PIC's public sector clients. Its liabilities are, therefore, dictated by the liability profile of those clients. Investments are structured so as to ensure money is available when clients require their capital.

In that respect, one would expect the biggest determinant of the PIC's outgoings to be the pension liabilities of the GEPF, the PIC's largest client. While broadly true, the government has given certain guarantees regarding the GEPF, since it is a defined benefit pension fund entitling members to their benefits. This means that those pensions will be paid, regardless of the performance of PIC in managing GEPF assets. Effectively, this exempts the PIC from direct liabilities since, in the event of a shortfall between the defined benefits and available funds due to PIC underperformance, the government has committed to covering the shortfall.

The fund is also legally protected from government drawdowns as the PIC's capital is to be used solely to benefit client organisations. Accordingly, the government of South Africa as owner and shareholder is prevented from accessing PIC's assets. For instance, the government cannot elect to draw down on PIC to finance a budget deficit or to fund any other public spending programme. In that sense, the fund is entirely quarantined from any interaction with the national budget or other public financial flows.

The only other explicit liability is a discretionary dividend payment to the government shareholder from PIC's returns. But these must first be authorised by the PIC Board and approved by the minister of finance. In this respect, the PIC's dividend liability is not rule-governed as it remains at the behest of the Board. This approach is similar to the arrangement between Temasek and its government shareholder, where the payment of dividends by Temasek to the finance ministry is negotiated annually between the fund's Board and government.

V. Governance structure

External governance

i. Savings and spending rules

There are no formal saving and spending rules governing PIC, other than a prohibition on the South African government's right to tap the fund for any financial purpose.

Funding for PIC comes from a variety of public sector bodies. There is no formal 'savings rule' requiring a certain volume of public assets be transferred to the PIC to achieve a savings goal since the fund is not a 'savings fund', but a pension fund. However, some PIC clients are required by their founding legislation to invest through the PIC, while others are not. In that sense, there is a 'quasi-transfer' rule in place under which some level of financing for the PIC is guaranteed. But the objective here is for the PIC to augment financial assets on behalf of clients to help those clients offset their liabilities, rather than to save for future generations. The spending of PIC assets is entirely influenced by the client's liability structure.

ii. Placement and reporting lines within the public sector

The PIC's public character derives from its management of public sector money and its ownership by the government of South Africa. While the fund seeks to align its broader investment objectives with the economic reforms, policies and priorities of the government, its operations as an incorporated entity give it substantial independence from the government-shareholder. Apart from reporting obligations to the minister of finance and parliament and to the clients whose monies the PIC invests, the fund is, on the whole, an autonomous organisation.

The fund is directly accountable to parliament for its financial management. At the end of PIC's financial year on 31 March, the annual financial statements are audited by the auditor-general and tabled before parliament as part of the PIC's annual report. While the PIC exclusively manages public sector funds, not all public bodies are PIC clients. The pension funds of municipal and local government employees are currently managed by private sector managers. However, the PIC is empowered by its founding Act to approach these entities and provide asset management service on their behalf.

The PIC is also independent from the macroeconomic architecture of the South African state. There is no permanent interaction between PIC and state assets through a transfer or withdrawal arrangement to the national accounts, nor is there a relationship to the Reserve Bank of South Africa.

iii. Transparency and disclosure

The PIC is a transparent fund, producing a comprehensive annual report and providing its annual financial statements to the auditor-general for auditing in compliance with the Public Finance Management Act 1999. These statements are ultimately reviewed by parliament. The PIC also regularly updates its fairly detailed website, giving it reasonable accountability to the South African citizens on whose behalf the fund invests. Board Directors also have unrestricted access – collectively and individually – to all PIC information, records, documents, facilities and property to enable it to discharge its responsibilities.

Internal governance

iv. Institutional governance

The PIC's primary internal governance mechanism is a 12 member Board of Directors, comprising a majority of independent non-executive Directors. The Chairman is traditionally non-executive and, ideally, independent as well. Nhlahla Musa Nene, the present Chairman of the Board, is also South Africa's deputy minister of finance, since 2008. He is non-executive, but non-independent given his government affiliations. The PIC has explained his appointment is based on the premise that the GEPF is a defined benefit fund, which is underwritten by government, the role of the Chairman and the chief executive officer are separate in the fund and that the PIC is a public entity owned by the state.

The 10 Directors consist of three executive Directors (the chief executive officer, chief investment officer and chief financial officer) and seven non-executive Directors considered to be independent. This composition is aimed at ensuring that there is a proper distribution and balance of power and authority in decision-making processes. The majority appointment of independent Directors is meant to encourage two aspects of good governance by non-executive Directors: (i) the objective review of the performance of both the Board and executives and (ii) the responsibility for the resolution of Boardroom conflicts of interest.

Both executive and independent Directors are appointed by the minister of finance, in consultation with the cabinet. Non-executive Directors are appointed on the basis of their skills, investment knowledge, business experience and qualifications. PIC clients also make nominations to the Board and the minister of finance must, according to the Act, 'have due regard' to such nominations.

In 2013/14, the Minister of Finance, in his capacity as shareholder, conducted a review of the PIC Board with a specific focus on Board members who have been serving for a period in excess of nine years. Based on this review, two independent non-executive Directors, namely Jan Strydom and Ignatius Sehoole, retired from the Board at the end of November 2013, replaced by three new Directors effective from 1 December 2013. Table 2 shows the refreshed Board of Directors, current as at December 2014.

Table 2: PIC Board of Directors as at December 2014

NAME	BOARD POSITION	OTHER APPOINTMENTS
Mr Mcebisi Jonas	Chairman	Deputy Minister of Finance
Mr Vujo Jack	Independent non-executive Director	Chairman: Audit and Risk Committee Chairman: Private Equity and Africa Fund Investment Panel
Mr Patrick Mngconkola	Independent non-executive Director	Chairman: Social and Economic Infrastructure and Environmental Sustainability Fund Investment Panel
Mr Roshan Morar	Independent non-executive Director	Chairman: Investment Committee Chairman: Priority Sector and Small Medium Enterprises Fund Investment Panel
Ms Moira Moses	Independent non-executive Director	Chairman: Property Committee
Ms Rejane Woodroffe	Independent non-executive Director	Chairman: Social and Ethics Committee
Mr Trueman Goba	Independent non-executive Director	Member of various Committees
Ms Dudu Hlatshwayo	Independent non-executive Director	Member of various Committees
Ms Sibusisiwe Zulu	Independent non-executive Director	Member of various Committees
Dr Daniel Matjila	Executive Director: Chief Executive Officer	Member of various Committees
Ms Matshepo More	Executive Director: Chief Financial Officer	Member of various Committees

The Board meets at least quarterly and more if necessary, and meets with management for at least two days annually to discuss proposed strategies.

In addition to its general oversight and monitoring role, the Board is specifically responsible for:

- Overall strategy;
- Acquisition and investment policy;
- Approval of major capital expenditure projects;
- Consideration of significant financing matters;
- Overseeing risk management;
- Monitoring exposure to key business risks;
- Employee-related matters such as appointing executive management and monitoring performance of the chief executive officer and executive team.

The Board is assisted by a number of sub-Committees comprised of a majority of independent, non-executive Directors and chaired by an independent non-executive Director, including:

01. The Investment Committee;
02. The Human Resources and Remuneration Committee;
03. The Directors' Affairs Committee;
04. The Audit and Risk Committee;
05. The Social and Ethics Committee and the Property Committee.

In 2013/14, the Board also established and mandated the property Committee and three Fund Investment Panels (FIPs), as subCommittees of the Investment Committee to assist the Board in discharging its statutory duties and responsibilities in relation to investment in South Africa and the rest of Africa. The three FIPs are:

01. Private Equity and Africa FIP;
02. Social and Economic Infrastructure and Environmental Sustainability FIP;
03. Priority Sector and Small and Medium Enterprises FIP.

The PIC is structured into two main components:

01. Asset management business, headed by the chief investment officer;
02. Operational functions, headed by the Chief Operations Officer.

v. Investment and risk management process

The PIC's investment policy is determined by its clients and stipulated through their mandates with the implementation overseen by the Board of Directors and assisted by the Investment Committee (IC) and its subCommittees. As a result, the PIC only invests in areas and instruments approved by its clients. To this end, the PIC does not invest in the gaming and gambling sectors.

The IC consists of eight members, six of whom are independent non-executive Directors with two executive Directors, typically the chief executive officer and chief investment officer. The IC assists the Board by monitoring investment mandates, policy, strategy and strategy implementation of all the PIC's investments, both internally and externally managed.

As noted above, a property Committee and three FIPs operate as subCommittees of the IC and aim to fast-track development investments which include those in economic infrastructure, environmental sustainability, social infrastructure, priority sector (high labour intensive sectors) and small, micro and medium Enterprises (SMMEs).

The PIC implements its investment strategy through its four investment divisions within the asset management side of the business:

01. Fixed income and dealing;

02. Listed equities;

03. Properties;

04. Isibaya (investment fund dedicated to domestic socio-economic development).

An additional 'bottom-up' influence on the PIC's investment policy comes from workers whose pension money sits in the PIC. Employee members have a say in how PIC money is managed by virtue of their trade union membership. For instance, in the case of the GEPF Board of trustees, trade unions are represented on a 50-50 basis with employer representatives. This means that trade unions are part of the process of setting the GEPF mandate provided to PIC. PIC also engages trade unions and other social representatives directly.

Risk management

PIC's risk management processes are detailed in the risk management framework. The framework is endorsed by the Board and its implementation is overseen by the Audit and Risk Committee (ARC) along with PIC's financial reporting, the adequacy and effectiveness of its systems of internal control, as well as risk management and consists of five independent non-executive Directors.

The risk and compliance division is responsible for the on-going measurement, monitoring and reporting of portfolio risk, counterparty risk, compliance risk and operational risk. This division is responsible for ensuring that portfolio managers manage the investment portfolios within the risk parameters of client mandates. The risk related to the potential returns of investments is measured using two metrics. The first of these is the total measure of risk, which measures the volatility in any given asset class. Different asset classes have different volatility and are exposed to different types of risk. The second metric for the measurement of risk is known as the tracking error, which is a measure of the extent to which a portfolio tracks a selected benchmark.

VI. Investment style and strategy

Consistent with the approach of many pension funds, the PIC is a conservative, non-diversified investor with the majority of its portfolio in the traditional asset classes of fixed income and listed equities (see Table 3 below). Within these assets, it is primarily a passive index-tracker. What differentiates the fund's investment style from many of its peer pension funds is its additional development mandate. While the generation of risk-adjusted returns for clients is its primary investment objective, the PIC treats its development mandate as compatible with its return-seeking obligation, focusing on longer-term investments that can satisfy both mandates.

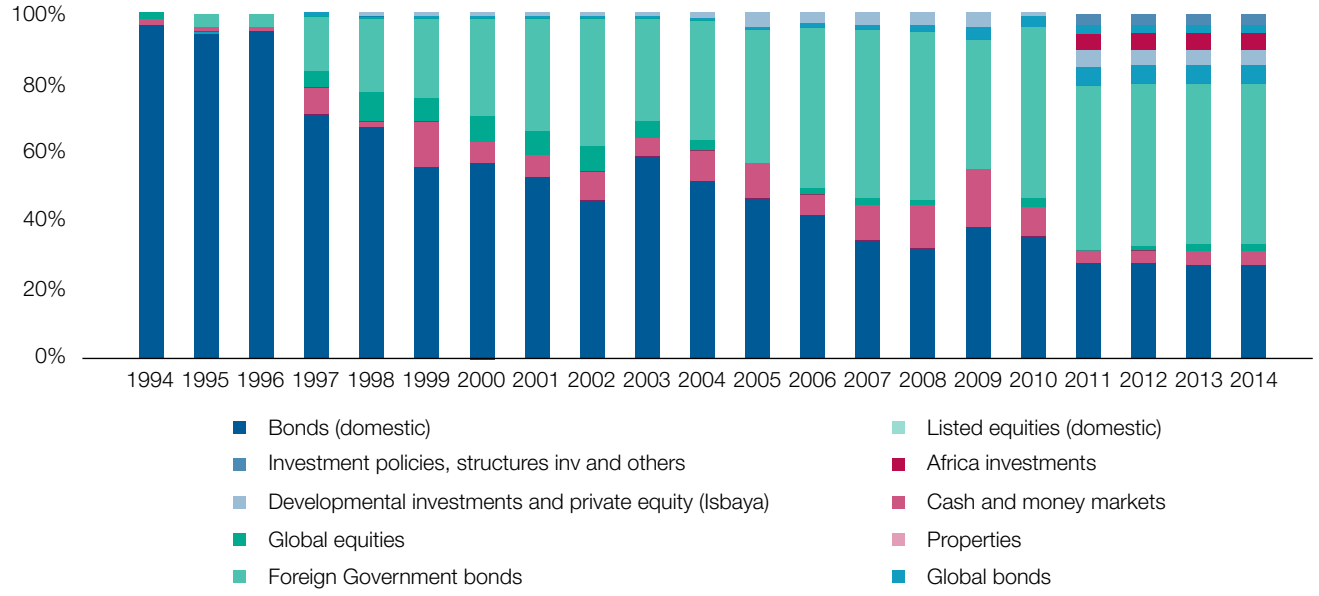
Table 3: Assets Under Management (as at March 2014)

ASSET CLASS	PERCENTAGE
Local equity	49.11
Local bonds	32.42
Cash and money market	7.12
Properties	4.39
Offshore equity	3.64
Offshore bonds	1.72
Africa Equity (Ex SA)	0.5
Isibaya	1.1

Source: PIC Annual Report 2014

For most of its 103 year history, PIC has only invested domestically. However, a 2010 change to the mandate of its largest client, the GEPF, resulted in an overdue geographic diversification of the portfolio with up to 10% of assets now available for allocation to international assets. Of this, 5% of the tranche is reserved for investments in Africa (excluding South Africa) with the other half going to global assets. This geographical broadening of the portfolio represents the most significant change to PIC's asset allocation, which has shown a gradual, but slow, tendency towards diversification across asset classes and sectors over the past 20 years (see Chart 1).

Chart 1: PIC Historical Asset Allocation Since 1994



Source: PIC Annual Report 2014

For the global allocation, former PIC chief executive officer, Elias Masilela, indicated that the focus will be on achieving risk distribution, with a strong interest in opportunities in the BRIC economies, particularly Brazil[2]. Given the sparseness of the listed markets across the African continent – with the total listed market constituting roughly 25% of the South African equities market – pan-African investments will focus on private equity, development financing (infrastructure) and property. This is reflected in the existing client mandates which are geared towards economic growth, job creation, infrastructure development, food security, education, housing, healthcare and energy.

Investment in those asset classes is consistent with PIC's goal to fuel South African development by contributing to growth in the African region, reminiscent of Temasek's strategy to cultivate opportunities for Singaporean domestic businesses by unlocking the economic potential of neighbouring economies.

To guide and manage the distribution of capital within Africa, PIC has indicated a preference for partnering with established local organisations within target African markets, similar to the relationship it enjoys with its 'sister company' Hareth Capital Partners within South Africa[2]. Senior management has indicated that local partnerships are preferable to establishing numerous satellite offices within destination markets[2]. Four memorandums of understanding have been signed with potential African investment partners.

PIC has identified the African Development Bank (ADB) as an ideal co-investor, given its sovereign clout and the importance of that in light of the political risks inherent in Africa-based investment. Other potential non-regional partners, with strong track records of African investment, include the Chinese Investment Corporation (CIC), the World Bank and Temasek, with whom PIC has recently been exchanging insights[2].

2. Author interview with Elias Masilela, 12 March 2014.

There is no priority listing of sectors or asset classes for the pan-African strategy. Investment will be opportunistic, but if previous investments are any guide, PIC has demonstrated strong interest in cement and retail banking. Management has also indicated a preference for debt-financing, private equity and property given the thinness of the listed markets in Africa. Finally, to ensure PIC rolls out its development mandate across the continent as well as domestically, it will prioritise investments that help unlock African economic development such as pipelines, roads, power generation, dam construction and any areas that ensure a crowding-in effect from the private sector investment.

Fixed income

All of the fund's fixed income activities are managed internally by a seven- person team. Currently, this includes domestic investments only, although this is changing in light of PIC's mandate to invest 10% of assets abroad. For now, all fixed income transactions still involve instruments listed on the Bond Exchange of South Africa (BESA) and other BESA members. The fixed income and dealings division use the All Bond Index (ALBI) to compare the performance of bonds and the STeFI (short-term fixed interest) Index to measure performance in the cash and money markets. PIC aims to outperform these indices and has consistently exceeded these benchmarks.

Equities

PIC is one of the largest investors in South African equities, contributing approximately 13% of the Johannesburg Stock Exchange market capitalisation. Three-quarters of the equities portfolio is internally managed on a passive (enhanced index) basis to minimize management fees for the GEPF, given its dominance of the PIC's portfolio. The other 25% is managed actively by external mandates. Following the 2010 change to the GPEF mandate, 10% of its equities fund can now be invested offshore. Half of this has already been deployed into global equities, mainly in the BRIC economies, while the remaining 5% will be invested in Africa (excluding South Africa). The Africa-based investments will focus on infrastructure and SME initiatives that help to promote sustainable economic growth.

Properties

PIC Properties manages property assets in commercial office, retail and industrial real estate properties throughout South Africa. The property portfolio is divided into the directly-held, indirectly-held and listed sub-portfolios. The directly-held portfolio is made up of those properties that are directly owned and held on the balance sheet of the GEPF. Title deed reflects the GEPF as the registered owner. The indirectly-held portfolio, on the other hand, is made up of properties where the GEPF is a shareholder in an unlisted property company.

Development investor

Within South Africa, the PIC invests according to four developmental pillars:

01. Economic infrastructure

02. Social infrastructure

03. Environment

04. SME development

It largely pursues this investing through the Isibaya Fund, a division of the PIC that invests in commercially-viable South African-based projects that have strong, positive developmental impact. Isibaya also seeks to co-invest with other institutions. It targets projects that support the long-term economic, social and environmental growth of South Africa. Since its mandate change in 2010, the PIC is now looking to identify investments throughout the African continent that also satisfy these four developmental pillars.

3. Author inverview with Elias Masilela, 12 March 2014.

Responsible investor

PIC is a signatory to both the United Nations Principles for Responsible Investment (UNPRI) and the Global Compact. To achieve PICs responsible investment objectives, environmental, social and governance (ESG) considerations are incorporated into its investment processes. PIC and GEPF have also established an ESG working Committee that looks closely at ESG issues in investments. Recently, PIC joined the Carbon Disclosure Project, with the aim of becoming a completely carbon neutral organisation in the near future.

Active investor

As part of its commitment to responsible investing, PIC aims to ensure that investee companies are well managed, accountable and transformed. This is done through proxy voting, engagement and reporting. PIC representatives attend all annual general meetings of such organisations and actively focus on issues of importance to shareholders, including empowerment and transformation. In addition, PIC participated in the development and refinement of various sector charters on black economic empowerment. The PIC in consultation with the Centre for Corporate Governance in Africa at the Business School of the University of Stellenbosch has developed a corporate governance rating matrix. This matrix is used to measure ESG performance of the PIC's listed investee companies.

In-house investor with limited external mandates

The PIC is predominantly an in-house investor. All fixed income investments and 75% of equities are managed internally. External mandates are used for 25% of the equities portfolio. Rather unusually for sovereign investors, the property portfolio is managed internally. For Isibaya, investments are managed internally or indirectly through private equity funds.

South Korea:
Korea Investment Corporation

► Key Features

– The Korea Investment Corporation (KIC) was one of several Asian sovereign funds set up to manage excess reserves accumulated in the wake of the Asian financial crisis. Its creation was part of a broader effort to revive and strengthen the South Korean financial sector;

– It is an unusual sovereign fund insofar as it has a broad, dual mandate to generate returns on its reserves investment (but not for any specified policy purpose) and also to develop its domestic financial sector by mandating local asset managers;

– Its primary governance mechanism is a nine-person steering Committee, comprised of six private sector professionals, the chief executive officer of KIC and representatives of the entrusting institutions (currently the governor of the Bank of Korea and the Finance Minister);

– The chief executive officer of KIC is appointed by the President of the Republic of Korea following recommendation by the finance minister who is in turn advised by the President Recommendation Committee and the steering Committee;

– Despite its development mandate to help stimulate the growth of the domestic financial services sector, the KIC has increasingly bought its asset management in-house, following significant underperformance during the global financial crisis. Today, the fund invests according to an alpha-beta separation strategy, undertaking index-replication investment in-house and only mandating external fund managers for alpha-generation where they have proven above-market performance. Some enhanced beta strategies are pursued internally.

Fund snapshot

Year Established	2005	
Assets Under Management (as at end 2013)	$72 billion	
Type of Funds	Reserce investment fund	
Source of Funds	Foreign currency reserves	
Wiithdrawals	None	
Portfolio at a glance (as at Dec 2013)	Traditional assets (equities, bonds)	82.7%
	Alternative assets (Hedge Funds, PE, Real I Estate, Cash)	8%
	Special Investments	1.6%
	Other investments	7.7%

I. Background: Economic and political context

Korea Investment Corporation is one of many Asia-based sovereign funds established in the wake of the Asian financial crisis of 1997-1998, as part of a concerted effort by governments throughout the region to insulate their economies against large foreign currency withdrawals and inflows. This precautionary strategy was made possible by the accumulation of substantial trade surpluses in most Asian developing economies, prior to and post the crisis, and the deliberate build-up of reserves from these surpluses by governments.

In the decade from 1997 to 2007, five sovereign funds in the Asian region were set up using rapidly accumulated excess reserves: Thailand created the Government Pension Fund in 1997, followed by Hong Kong's Exchange Fund Investment Portfolio in 1998, Taiwan's National Stabilisation Fund in 2001, the Korea Investment Corporation in Seoul in 2005 and the China Investment Corporation in 2007.

But the establishment of KIC cannot be understood solely in terms of a defensive strategy; it was also part of a proactive effort to drive the recovery and growth of the Korean financial sector following the Asian financial crisis. In 2003, the South Korean president adopted, the 'Northeast Asian Financial Hub Strategy' as a national policy initiative. The strategy called for the transformation of Korea into a regional financial hub led by the asset management industry. The combination of a low interest rate environment and an ageing society also spurred interest in improving the efficacy of the local asset management sector.

During this time, the KIC was influenced by the growing number of governments and high profile universities establishing investment entities to manage their surplus funds. These various factors combined and led to the passing of the Korea Investment Corporation Act in March 2005, with the official launch of KIC on 1 July 2005.

Although most of KIC's assets are still counted as reserves, the KIC has at least 50% of its portfolio in equities and alternatives. The aim is to earn a higher return on the reserves and to improve the sophistication of the domestic financial sector, by introducing global investing know-how to domestic asset managers and sharing the market information obtained via global investing with the public.

II. Official mandate(s)

KIC is commonly characterised as a reserve investment corporation, given its fundamental mission to earn higher returns on Korea's ample foreign exchange reserves. These reserve assets may be entrusted by the government, the Bank of Korea (BoK) or other public funds to KIC for effective management. A further motivation for the creation of KIC was the desire to develop the domestic financial industry and transform Korea into a regional financial hub, making it somewhat akin to a development sovereign fund. KIC expresses this mission through a two-fold institutional mandate to:

01. Consistently and effectively increase national wealth by generating returns that exceed inflation to share wealth across generations;

02. Contribute to the development of Korea's financial industry.

The fund's investment mandate to 'achieve stable and continuous returns exceeding the benchmark within an appropriate level of risk' is rather nebulous and broad, relative to other sovereign funds. This is partly because KIC has no defined liabilities to help provide a mandate bar or define a return target. In the absence of a fund-wide performance target, the sponsors (BoK and the Ministry of Finance) have identified relevant benchmarks for individual assets classes. For most of the portfolio, the performance benchmark is index-linked, but for a small part of the alternatives portfolio there is an absolute return target.

Table 1: Performance benchmarks

ASSET CATEGORY	ASSET CLASS	BENCHMARK
Traditional Assets	Equities	MSCI Index
	Bonds	Barclays Capital Global Aggregate Index
	Inflation-linked bonds	Barclays Capital Global Inflation-Linked
	Commodities	S&P GSCI Light Energy
Alternative Assets	Hedge fund	G7 inflation + 5%
	Private equity	
	Real estate	

Table 2: History of funding tranches

DATE OF TRANSFER	SOURCE	AMOUNT
June 2006	Bank of Korea	$17 billion
October 2006	Ministry of Finance and Economy	$3 billion
November 2007	Ministry of Finance and Economy	$10 billion
Total initial entrusted assets (End 2007)		$30 billion

Source: KIC

Since that time, there have been additional tranches of funding transferred from both sponsors and the 2013 Annual Report indicated that more capital transfers are expected 'in the near future.' To date, KIC has received the equivalent of 100 billion won, in paid-in capital.

IV. Liabilities

KIC is part of a small constituency of sovereign funds that has no defined liabilities. In 2011, then chief investment officer, Scott Kalb, a former hedge fund investor, described the absence of an explicit liability profile at KIC and the advantages:

'We don't have a liability stream, so our job is to protect and grow this capital for the benefit of future generations in Korea. [The government] haven't yet defined how this money is going to be spent – we hope it will be spent on positive social infrastructure, or other things that will benefit the people – but in the meantime our job is to protect it and grow it… [A]nd if you are a sovereign wealth fund without a liability stream, one of your biggest advantages is a long-term investment horizon.'[1]

In the past few years, KIC has sought to capitalise on its liability-free status by developing a more sophisticated investment strategy, something that commenced under Kalb's watch and continued under successive chief investment officers, with the fund becoming more diversified and alpha-seeking.

1. Chris Wright, 'Inside the Korean Investment Corporation', Euromoney, April 2011, at http://www.chriswrightmedia.com/inside-the-korea-investment-corporation/

Drawdowns

Although the fund is free of explicit liabilities, it is not protected from drawdowns by the government or withdrawals of its capital from its client organisations. Neither KIC's founding Act, nor any other legislative instrument regulating its behaviour, expressly prohibits a drawdown by government.

Equally, either BoK or the Ministry of Finance, as KIC's two key clients, could reclaim any or all of their entrusted assets, although this has not happened to date. The possibility of a decrease (ie. withdrawal or investment underperformance) in the fund's initial seed capital of 1 trillion won is envisaged in the KIC Act and Articles of Incorporation, both of which mandate the steering Committee to modify the financial status of the KIC, including any increase or decrease to its capital.[2]

Article 35 of the Articles of Incorporation explicitly declares the profits from management of the entrusted assets to be the property of the entrusting clients[3]. Both clients are represented on the steering Committee with the finance minister and the governor of BoK holding seats.

V. Governance structure

External governance

i. Saving and spending rules

KIC is rule-governed, in terms of its initial seed capital, but not in terms of on-going capital injections, which are discretionary. Both its founding Act and Articles of Incorporation required the South Korean government to transfer 1 trillion won to the fund to ensure its establishment. While there is no permanent rule requiring regular injections to the fund, such transfers have occurred on a sporadic basis. In 2014, senior management indicated that they expect more to take place in the coming years to help KIC reach US$100 billion assets under management 'in the near future'.

KIC's spending is also not rule-governed. To date, it has no defined liabilities or legally prescribed policy purpose to serve. The steering Committee is permitted to decrease the fund's capital and thus, could withdraw KIC assets for transfer back to one or both of the ultimate owners of the entrusted capital (the BoK or Ministry of Finance). However, no such transfer has occurred to date, and it is not clear how such a withdrawal process would work. The government could also, in theory, drawdown on the fund's assets for its own purposes, but has not done so in the past.

ii. Placement and reporting lines within the public sector

Unlike many sovereign funds whose assets are relatively quarantined from the rest of the sponsor state's public finances, parts of KIC's assets are closely linked into the management of Korea's official reserves. This is partly explained by KIC's status as a reserve investment corporation with BoK reserves constituting a significant portion of KIC's seed funding and also a result of the overarching design of Korea's macroeconomic architecture. The capital entrusted by the BoK is managed separately to that entrusted by the Ministry of Finance.

Some of KIC's assets are counted as foreign exchange reserves and others are not. The BoK and the Ministry of Finance decide which assets to include in the reserves in light of IMF guidelines that specify what exchange capital may be used for reserve management. Most of the assets entrusted by the Ministry of Finance (in the foreign exchange stabilisation fund) are included and all assets entrusted by the BoK are counted as the foreign exchange reserves. The remainder of the KIC's assets, deployed to alternative and strategic investments and low-grade bonds (BB or lower), are excluded. This amounts to roughly 10% of the portfolio. Given the ultimate purpose of the KIC is to manage excess reserves to achieve portfolio diversification and higher returns, managing all of KIC's assets in a reserve-like manner – investing only in liquid assets, such as stocks and bonds – would prevent the fund from achieving its mandate.

2. Article 9(4), Articles of Incorporation, p. 1; Article 9(4), Korea Investment Corporation Act 2005, p. 3.
3. Articles of Incorporation, p. 8.

iii. Transparency and disclosure

Along with Kuwait's KIA and Norway's GPFG, KIC is one of the world's few large funds structured to allow direct public scrutiny of its behaviour. It is required by law to disclose financial statements, audit reports, total assets under management and more unusually mid- and long-term investment policies, asset mix, and its return on total assets under management. This information is all publicly available in its annual reports and on its website.

It is also required by law to report on its business activities to the National Assembly, who may conduct annual inspections of KIC as well as order an audit by the Board of audit and inspection. In addition, the steering Committee can mandate an outside agency to conduct part of its oversight functions of KIC, including auditing. This may occur in addition to the external audit selected and appointed by KIC's statutory auditor.

KIC is also one of a small number of SWFs to reside in a robust democracy, along with SWFs in Norway, Australia, New Zealand and Italy and, to some extent, Singapore. As a result, there is a relatively healthy degree of public interest and debate concerning its performance and behaviour. KIC suffered extensive public fury over its $2 billion investment in Merrill Lynch at the height of the financial crisis, with the National Assembly undertaking investigations into the fund. In 2014, the newly appointed chief executive came under attack from the opposition party over comments he made on Twitter in 2012 regarding the then presidential candidate.

There are areas for improvement though. Although KIC rates relatively well on the Truman ScoreBoard, one of the better-known indexes of SWF transparency and accountability – it is not as a top performer. However, between 2007 and 2010 the KIC substantially improved its transparency and disclosure, partly as a result of its investment experiences during the financial crisis, elevating its Truman ScoreBoard ranking during that period. This increased transparency is commendable, given the KICs role in managing Korea's exchange reserves, which demands a certain level of confidentiality.

Internal governance

iv. Institutional governance

KIC's governance arrangements are described as 'two tier' and consist of three key players: the steering Committee on one level and the chief executive o fficer and Board of Directors, consisting of senior fund management on the other level (see Figure 1).

The President of Korea appoints the chief executive officer, following a recommendation from the minister of finance and strategy through the president recommendation Committee, reviewed by the steering Committee. The Board consists of four members from the fund's senior executive management with the Chief Executive Officer as Chairman. The Board is responsible for daily operations, while the steering Committee, consisting of nine members mostly from the private sector, determines the ultimate investment strategy and policy direction of KIC.

The Chief Executive Officer also sits on the steering Committee, the majority of whose members are civil society and private sector professionals, appointed by the President of Korea following nomination by the civil member candidate nomination Committee. The six private-sector professionals are nominated for a two-year term and the steering Committee Chairman is elected from among these six civil society members, again attempting to ensure a degree of independence.

While these arrangements – in particular, the majority appointment of external professionals to the steering Committee – reflect some attempt to ensure independence and autonomy from the government, in practice, the KIC has suffered from the taint of politicised leadership from its inception, mainly concerning the position of chief executive officer. In its first three years, the KIC had three chief executive officers, one of whom was appointed immediately after the inauguration of a new president in 2008. The appointment of Scott Kalb, in 2009, was widely seen as an effort to ensure greater independence of KIC's governance. However, the fund has recently experienced substantial volatility in its senior management team, again raising questions over its autonomy and 'arms-length' operation from the government.

A new chief executive officer, Hongchul Ahn was appointed in December 2013 amid controversy over his connections with Korea's president, fuelled by the immediate resignation of well-respected and internally promoted chief investment officer Dong-Ik Lee. This was KIC's fifth chief executive officer in seven years.

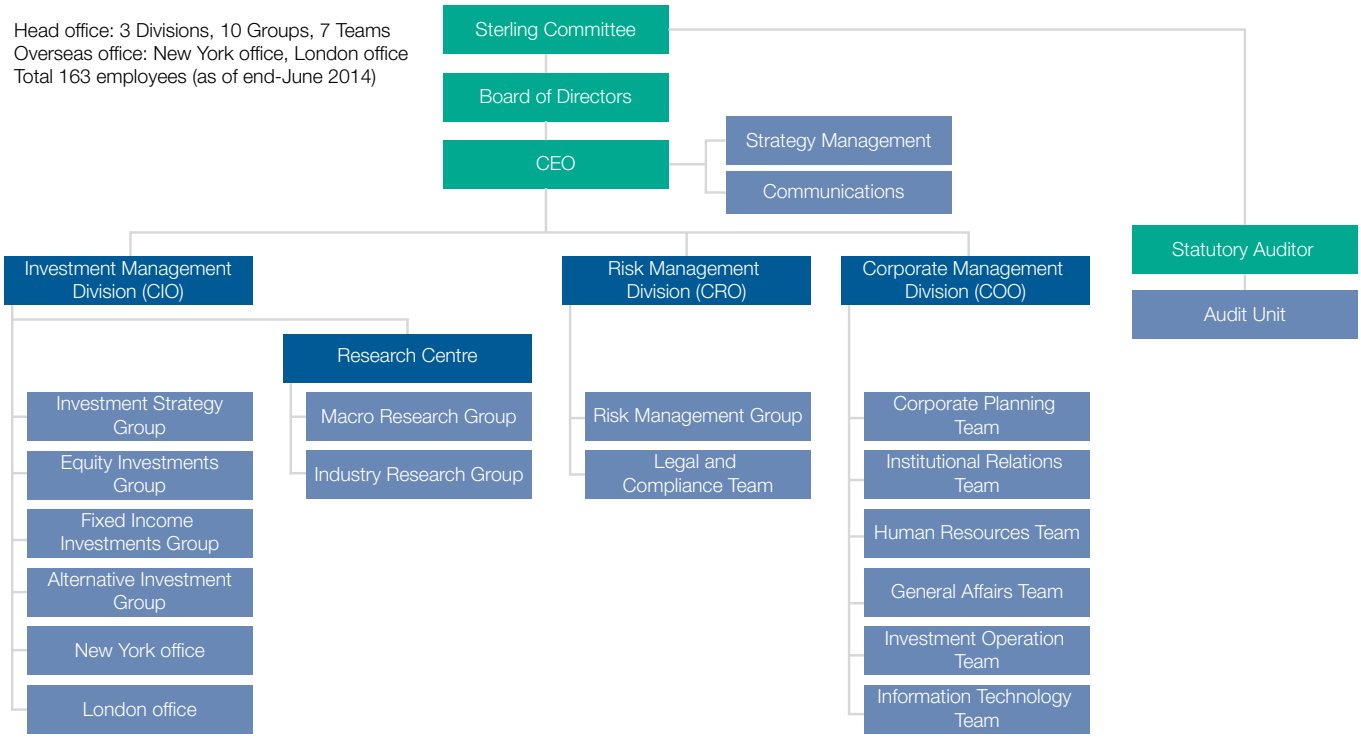
In March 2014, Heung-Sik Choo, the former head of reserve management at the BoK was announced as chief investment officer, perhaps signalling the government's desire to offset the perception of entirely politicised leadership at KIC through the choice of a technically credible financial bureaucrat with a strong track record in Korea's public service.

Steering Committee

The highest governing body is the steering Committee, made up of nine members including KIC's chief executive officer, the finance minister, the governor of the BoK and six South Korean private-sector professionals from finance, academia and major corporates. The steering Committee acts as a supervisory Board and is meant to ensure 'arms-length' operation from the government, although the government is represented on the Committee through the finance minister.

The finance minister and the governor of the BoK sit on the steering Committee as representatives of institutions that each entrusted more than one trillion won in assets to KIC. The implication is that any other public sector organisation that entrusts this volume of capital would also gain a voice on the steering Committee. Although this governance model attempts to ensure independence from the government, the fact that KIC's two largest asset owners (the ministry of finance and BoK) sit on the Committee could compromise autonomy.

Figure 1: KIC's organisational structure



Current members of the Steering Committee include:

- Minister of Strategy and Finance (Finance Minister);
- Governor of the Bank of Korea;
- Chief Executive Officer of KIC;
- Six professionals from the private sector:
  - Ke-Sop Yun (Chairman), Emeritus Professor, Seoul National University;
  - Kang Shin-Woo, chief executive officer/president, Hanwha Asset Management;
  - Jung-Chul Rhee, Chief Executive officer , Hi Asset Management;
  - Ryu Sang-Ho, Chief Executive Officer, Korea Investment & Securities Co., Ltd.;
  - Wood-Kyu Park, Senior Advisor, SK Telecom;
  - Kyungsoo Chung, Executive Vice-President/ Chief Executive Officer, Dongbu Insurance.

The steering Committee oversees the strategic direction and basic policy of KIC, deliberating on:

- Amendment to the Articles of Incorporation;
- Mid and long-term investment policies of KIC;
- Basic policies for the business of KIC;
- Modification of financial status, such as increase or decrease of capital, of KIC;
- Entrustment of assets to KIC;
- Appointment and dismissal of the officers;
- Approval of budget and account settlement of KIC;
- Evaluation of management performance of KIC;
- Inspection of the business of KIC;
- Any other matter pertaining to the operation of KIC.

Board of Directors

Day-to-day operations of KIC are overseen by a Board of Directors, consisting of the chief executive officer and three Directors, chosen from within the ranks of KIC's senior management. Directors are appointed (and dismissed) by the chief executive officer, who chairs Board meetings, following the steering Committee's review. Accordingly, the chief executive officer wields substantial power over the small three member Board. The current Board includes:

- Chief Executive Officer, Hongchul Ahn;
- Chief Operating Officer, Young Kim;
- Chief Investment Officer, Heungsik Choo;
- Chief Risk Officer and Compliance Officer, Taegki Hong.

The Board considers matters that must ultimately be referred to the steering Committee:

- Management of assets entrusted by the government and institutional investors;
- Use of emergency funds and carrying forward of the budget;
- Overall research and studies to improve asset management efficiency;
- Exchange and cooperation with related institutions and authorities.

Chief Executive Officer

The chief executive officer of KIC is appointed by the President of Korea following recommendations by the finance minister, who in turn follows the advice of the President Recommendation Committee and the steering Committee. The Chief Executive Officer represents KIC on the steering Committee and the Board of Directors, as well as externally. A new Chief Executive Officer, Hongchul Ahn, was appointed in December 2013.

v. Investment and risk management process

The steering Committee is mandated to determine high-level investment and risk management policy for KIC including the:

– Mid and long-term investment policies;

– Annual investment plan;

– Risk management policies;

– Alternative investment in real estate which exceeds US$0.5 billion or securities issued by a single company whose amount exceeds US$200 million or 20% of the total shares of the company.

Two sub-Committees assist the steering Committee on matters relating to mid and long-term investment and risk policy. These are:

01. The investment steering Committee;

02. The risk management steering Committee.

Each sub-Committee has four members. KIC's chief executive officer sits on both the investment and risk management sub-Committees, along with three independent steering Committee members, one of whom is on both sub-Committees. Neither the minister of finance nor the governor of the BoK sits on these sub-Committees.

The investment sub-Committee establishes and revises investment policies and drafts the annual investment plan while the risk management sub-Committee establishes and revises risk management policies and a status report of annual investment performance. The responsibility for formulating detailed measures lies with the risk management division.

Both sub-Committees have separate divisions supporting their work – the investment division and the risk management division (see Figure 1) – this strict separation is a product of the radical organisational changes at KIC in the wake of the financial crisis. At this time, a new position of chief risk officer was created to improve its management of market risk.

VI. Investment style and strategy

Today, KIC is a diversified investor with global holdings in equities, fixed income, commodities, real estate, hedge funds, private equity and special investments. It is both an index-tracking and active investor, with a strong preference for in-house management for passive, beta strategies. It has also begun to develop some alpha-seeking capabilities in-house.

When KIC commenced investing life in 2006, it was a relatively conservative investor holding all of its assets in publicly-traded fixed income and equity with 70% in bonds alone. Although KIC was permitted by its founding Act to invest in marketable securities (including stocks and bonds), foreign currencies, derivatives and real estate (with only investment in won-denominated assets and direct investment in real assets precluded), it took the financial crisis to prompt its rapid evolution into the diversified portfolio of today.

KIC had only just launched its first equities investment and in-house fixed income investment capability and was moving rapidly to fully invest its initially entrusted assets, when the sub-prime mortgage crisis hit in September 2007. Between February and December 2007, KIC went from a US$1 billion market exposure to $14.8 billion of capital deployed across stock and bonds with the lions' share in bonds.

In July 2007, cumulative returns reached their highest level since KIC's inception before commencing a steady plummet to all time-low in mid-2008. The sharp fall in the first half of 2008 was largely due to a US$2 billion investment in ailing bank Merrill Lynch, KIC's first direct investment outside the fixed income class. The fund recorded a -31.71% total rate of return in 2008, down from 7.4% in 2007. Both years underperformed the benchmark, prompting a strategy rethink.

The rocky start accelerated the pace of portfolio diversification with a greater share of assets allocated out of fixed income into equities. It also hastened KIC's move into alternative assets. While in 2007, the Annual Report only fleetingly mentioned the possibility of alternatives, one year later, KIC had produced a blueprint for an alternative investment strategy and marked the second half of 2009 for the launch of this portfolio.

This defensive strategy overhaul was accelerated by Scott Kalb, who during his tenure from 2009 to 2012, introduced an alternatives investment programme and the separation of the alpha and beta strategy. Passive management strategy was bought entirely in-house, while external managers were only mandated for alpha generation in 2009; a special investments programme and emerging markets exposure came in 2010; and a long-term growth strategy came in 2011. In 2012, the fund launched direct investments into mainland China.

In 2013, former chief investment officer Dong-Ik Lee announced an intention to triple KIC's allocation to alternatives spending between $5 billion and $10 billion to increase the alternatives exposure from 6.1% (at end-2012) to roughly 20% by 2016. This move was part of an effort to achieve more stable returns, but whether it is pursued under the incoming chief investment officer Heungsik Choo, appointed in March 2014, remains to be seen. Choo's appointment could mean the continuation of predecessor Donk-Ik Lee's diversifying, return-seeking strategies, as Choo is known for his progressive investment approach at the BoK, where he diversified the portfolio into corporate fixed income and equities.

In-house investor with limited external mandates

Since the financial crisis, KIC has committed to reducing fees incurred through external managers, a move that is at odds with its basic purpose of helping cultivate the domestic fund management industry. In its early investment life, the fund aimed to swiftly outsource assets to external mandates. However, the dramatic underperformance of the fund in 2008 reversed this trend, prompting a rapid retreat in-house. As reflected in Table 3, by the end of 2009, the majority of KIC assets were, once again, managed internally. While the alpha-beta separation strategy means that alpha-seeking mandates are given to external managers, KIC's in-house investment strategies have still had to evolve beyond passive index replication to enhanced strategies to meet its investment mandate.

Table 3: In-house versus external management 2007-2010

YEAR	IN-HOUSE MANAGEMENT	EXTERNAL MANAGERS
2007	100%	0%
2008	35%	65%
2009	65%	35%
2010	70.7%	29.3%

Source: KIC Annual Reports

Today, KIC outsources asset management to over thirty fund managers, but the newly appointed chief investment officer indicated a desire to resist pressure to outsource to domestic asset managers. At the same time, KIC has recently announced it will outsource China A-shares to Korean asset managers.

Important information

The information contained in this document is believed to be reliable but may be inaccurate or incomplete. Any opinions stated are honestly held but are not guaranteed and should not be relied upon. This communication is provided for general information only and is not an invitation to make an investment nor does it constitute an offer for sale.

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