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Building a long-term sustainable SWF under the Santiago Principles

Speech by Hon Peter Costello AC, Chair of the Future Fund Board of Guardians at the 7th Annual Meeting of International Forum of Sovereign Wealth Funds in Milan, Italy

Check against delivery.

Sovereign Wealth Funds are diverse

It is well recognised, particularly in this room, that Sovereign Wealth Funds are created for diverse reasons.

For some the focus is on turning a depleting asset such as oil into perpetual financial assets.

For others the focus is macro-economic stabilisation or currency stabilisation. Such funds are designed to reduce the impact of external shocks on a country's economy and its budget which is important for countries with a high level of exposure to commodity price volatility.

A third group can be described as development funds, with a focus on providing support for development objectives by holding and allocating resources to priority areas.

Finally there are intergenerational savings funds like the Future Fund. Such funds are designed to allow countries to save today to meet the costs of tomorrow.

Now of course, in practice, Funds may have more than one of these characteristics, but these descriptions capture the broad rationale for various types of Sovereign Wealth Funds. As well as having diverse purposes, the constitutional and legal arrangements and investment practices of Sovereign Wealth Funds are similarly diverse.

Today I want to refer to some of the most important of the Santiago Principles[1], principles that we have found important at the Future Fund and principles that I believe to be of value to all the different types of SWFs.

But first let me outline the nature and purpose of the Future Fund.

[1] Principles developed by the International Working Group of Sovereign Wealth Funds in 2008

Establishing the Australian Future Fund

In 2002, for the first time, the Australian Government published an Intergenerational Report which was designed to assess how current generations were preparing for the needs of future ones. It required an examination of the country's fiscal outlook over the long term. It identified emerging costs that required early attention, particularly costs associated with an ageing population.

It showed that over a forty year time frame, on then current policy, a gap would open up between expected spending requirements and expected revenue of about 5% of GDP per annum. It highlighted the fact that we needed to get a grip on the long-term drivers of expenditure if we wanted to avoid leaving an intolerable tax burden to future generations.

As a result, the Government brought forward a range of policies to restrain the growth in government spending and set about policies that would boost long-term growth and revenue.

We also established a Future Fund with the specific purpose of putting aside money to meet future liabilities that would have to be funded from the Budget at a later time.

In 2006 we seeded the Fund with $60.5 billion from Budget surpluses and some proceeds from the privatisation of the nationalised telecommunications company, Telstra. Investment returns since commencement have seen this grow to A$117 billion as at 30 June 2015, a return of 8.0% per annum since inception.

By growing these assets we have strengthened the Government's Balance Sheet. When a future Australian Government draws down on those assets it will be able to narrow the expected revenue-spending gap which will benefit future generations.

Prominence of Sovereign Wealth Funds

Sovereign Wealth Funds have existed for many decades but became more prominent in the mid to late 2000s.

In 2005 assets under management by sovereign funds were estimated at $1.5 trillion[2].

Two years later assets under management had doubled to around $3 trillion in large part driven by rising natural resource and commodities prices.

The growing pool of sovereign fund assets searching for investment opportunities made them much more visible.

At the time there were also a number of high profile investment proposals from State-Owned Entities looking to invest in developed markets. Examples included the proposed acquisition of six US port facilities by Dubai Ports World, the proposal by China National Offshore Oil Corporation to acquire US-based Unocal Oil Company and the purchase of a 5% stake in European Aeronautic Defence and Space by a Russian bank.

These were not deals involving Sovereign Wealth Funds. They were proposals involving State-Owned Enterprises (SOEs). Nonetheless, the distinction between an economically and financially focused investor in financial assets and a state-owned operating company was not always well understood.

More broadly, the growth of emerging economies and the shift of savings away from the United States and Europe, meant the emerging world was beginning to invest in developed economies. The world was used to the reverse. This was a surprise to the established order. In some quarters it fanned hostility to foreign investment.

For some, the growth in size of SWFs, the activity of SOEs and the change in the established economic and financial order was threatening. Others questioned whether this was genuine investment or the pursuit of geopolitical influence by other means.

In response, an effort to address these concerns and provide a framework for better understanding of Sovereign Wealth Funds was begun under the auspices of the IMF. The International Working Group of Sovereign Wealth Funds was established which developed what we know today as the Santiago Principles. They were finalised in 2008, just at the time of the severe financial crisis in U.S. and European markets.

[2] Truman, Edwin M. Sovereign wealth funds: threat or salvation? 2010.

The advent of the financial crisis at around this time changed the dynamic again. Sovereign Wealth Funds began to be seen less as a cause for concern (a threat) and more as a source of much needed, stabilising capital (a benefit). The hostility to SWFs abated as western financial institutions scrambled to get assistance from them for recapitalisation.

Nonetheless the Santiago Principles then and now provide a very valuable service. They are designed to provide a “best-practice” template. Those Funds following them can use them to provide confidence about their motivation and activities. In turn this should provide the benefit of easier access to investment in developed markets.

Implementation of the Principles can also provide an additional source of confidence in the operations of a Sovereign Wealth Fund among domestic stakeholders, enhancing the ability of the SWF to pursue its investment objectives.

The Principles also offer a framework to help guide countries that are setting up a Sovereign Wealth Fund. They are a useful summary of what constitutes best practice and a template to follow. In this regard it is particularly pleasing to note the constructive engagement that takes place between more well-established funds and newer members of this Forum.

Application of the Santiago Principles at the Future Fund

As I have explained, the Future Fund’s structure, governance and investment approach pre-dated the Santiago Principles but nonetheless it implements them fully. That is because we recognise as good practice the policies they recognise as good practice.

Each year our Annual Report provides a detailed review of how we implement the Santiago Principles. In the time I have available today I would like to call out a few of the key aspects of our approach.

<u>Principle 2</u>

Principle 2 calls for the policy purpose of the Sovereign Wealth Fund to be clearly defined and publicly disclosed.

In the case of the Future Fund, the purpose is articulated in the founding legislation. The Fund was established to help offset unfunded future pension liabilities and in doing so ease pressure on future Budgets at a time they are under the strain of an ageing population.

Since the Fund was created, our organisation has also been given responsibility for managing three Nation-building Funds, a Disability Care Fund and more recently a Medical Research Future Fund. These funds have different purposes.

In each case, the policy purpose has been enshrined in legislation.

This helps us by providing a stable platform and confidence that our objectives will not be changed for short-term political expediency.

Such clarity of purpose also supports the development of a robust and focused investment strategy and provides a clear signal of our priorities and how we will behave.

Principle 16

Principle 16 calls for the governance framework and objectives of the Sovereign Wealth Fund and the operational independence of management from the owner, to be publicly disclosed.

Again, the Future Fund's governance arrangements are very explicit. The responsible Ministers appoint Board members and set the Investment Mandate. In doing so they may only appoint Board members with requisite experience and credibility in investing, managing investments or corporate governance.

The Ministers may not, under legislation, appoint serving politicians, government employees or people susceptible to government influence. They cannot remove Board members arbitrarily.

What is more, legislation removes the Fund's operations from the political process of the Budget. All the costs we incur in investing and managing the Funds are met from the earnings of the Funds themselves, not through appropriations. This distances the Fund from the political process.

Legislation also makes clear the arrangements for contributions and withdrawals from the various Funds by Government and the process for setting the specific Investment Mandate for each Fund. In each case the emphasis on pursuing risk-adjusted returns is enshrined in law and the responsible Ministers may not set objectives for the Fund that are inconsistent with that.

Our Board is called a Board of Guardians. They are called Guardians because part of their role is to guard the assets of the Fund from the Government itself should it ever try to tamper with them.

The Board must be consulted by the Ministers on the Investment Mandate and any changes to it. If the Board makes a submission in relation to a Mandate or a proposed change, that submission must be made public through Parliament.

With any legislative change and any Investment Mandate change having to go through Parliament there is no scope for governance frameworks or objectives to be changed without full public knowledge.

<u>Principle 17</u>

Principle 17 proposes that relevant financial information regarding the SWF should be publicly disclosed to demonstrate its economic and financial orientation, so as to contribute to stability in international financial markets and enhance trust in recipient countries.

It is suggested that this would normally include asset allocation, benchmarks and rates of return over appropriate time periods.

Legislation requires us to table an Annual Report, including audited financial statements, in Parliament. We are required to report on our investment performance and costs. We regularly appear before a Committee of the Senate to respond to questions about our investment program and operations. What is more, we actively engage with the industry and media to explain our progress and performance.

Now there is a question here, about how long-term investors manage the reporting of short-term results. For our part we find that regularly communicating our progress and providing context and insight is an important part of explaining our long-term objectives and our financial orientation.

<u>Principle 19</u>

Principle 19 deals with the issue of making investments on grounds based on considerations other than economic and financial ones. The Principle explains that if non-financial considerations are brought in to investment decisions this should be publicly disclosed and that management of Sovereign Wealth Fund assets should be consistent with generally accepted principles of sound asset management.

In establishing the Future Fund, the Australian Government gave it a pure focus on maximising risk adjusted returns. The Fund has no additional objective.

It is not tasked with stabilising the currency. It is not tasked with supporting Australian industries – whether that be mining, renewable energy or manufacturing.

This arrangement reflects the view that the best way to maximise risk-adjusted returns is for investors to be free to invest broadly and to invest where there is a sound investment case.

In fact the Future Fund Act goes further. It explicitly prevents the Government from directing the Future Fund to invest in particular activities or entities. It prohibits the Ministers from providing an Investment Mandate or objective that is inconsistent with the overarching objective of maximising risk-adjusted returns.

The legislation also requires the Board to exercise its investment functions in a manner consistent with international best practice for institutional investment. You will see evidence of how we approach this through our activities in the market and in our public comments and our annual report.

Nonetheless, the Board itself has formed a view that there are a limited number of economic activities that the Fund should not invest in. The Board will not invest in activities banned by international conventions to which Australia is a signatory for example landmines and cluster-munitions. Also, the Board does not invest in tobacco products.

Our policy on this is published on our website as is a list of the companies we exclude from the portfolio.

Beyond that, it is prudent for us as an investor to consider as broad a universe of investment opportunities as possible and in doing so we and our external investment managers, assess the material risks and expected rewards. This includes risks around governance, regulatory change, supply chains, environmental and other issues.

In each instance, the decision to hold, increase or decrease an exposure is a financial one, based on the consideration or risks and reward as part of an investment case.

What the Santiago Principles achieve

As I mentioned earlier the Santiago Principles provide a framework for countries that are establishing Sovereign Wealth Funds. They provide a means to allow established Funds to benchmark themselves against best practice.

But a key driver for the establishment of the Santiago Principles was to address concerns in developed markets about Sovereign Wealth Fund motives and to protect the free flow of investment, delivering benefits to the investor and the recipient of that investment.

It is my view that Sovereign Wealth Funds that implement the Santiago Principles should be recognised and acknowledged. The Principles are designed to enhance transparency and to demonstrate that investments are made for financial reasons and not as an arm of some other political objective. For that reason there should be smoother access to investment markets.

That is not to say the Principles provide carte blanche for any and all investments. Countries will always retain the right to protect national security but this is a much more limited area than the broad sweep of the economy including economic infrastructure.

The ability of a Fund to demonstrate its application of the Santiago Principles is an important signal that the Fund complies with applicable regulatory and disclosure requirements, that it invests on the basis of economic and financial risk and that it has appropriate governance arrangements in place.

We should be pleased to operate within the framework the Santiago Principles and continue to recommend them as best practice to the newly established Sovereign Wealth Funds being set up around the world.

And we should continue to encourage countries that receive inward investment to recognise and acknowledge SWFs that comply with the Santiago Principles as suitable and beneficial investors.

This will help to promote free flowing investment, contribute to a stable financial system and enhance global growth, while supporting the achievement of important national economic objectives. That is why the Santiago Principles provide a blueprint for sustainable SWFs and that is why the work of this forum is so important.

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