BOPCOM-08/19

Twenty-First Meeting of the
IMF Committee on Balance of Payments Statistics
Washington, D.C.

The Statistical Work on Sovereign Wealth Funds

Prepared by the Statistics Department
International Monetary Fund

Contents Page

The Statistical Work on Sovereign Wealth Funds

A. Introduction

1. At the meeting of the IMF Committee on Balance of Payments Statistics (Committee) in 2007 the Committee discussed the treatment of Sovereign Wealth Funds in balance of payments and IIP data. It concluded that:

2. "The Committee supported work by the IMF's Statistics Department to confirm the understanding of member countries' treatment of SWFs in the various external statistics datasets, as set out in table 1 of the paper (BOPCOM 07/07) ... The Committee encouraged the IMF's Statistics Department to be actively involved in efforts to expand and improve statistical information on SWFs, both by developing a definition in consultation with Committee members and by providing statistical expertise in the ongoing discussions in the Fund and elsewhere."

3. This note sets out developments on these issues since last year's meeting and discusses the way forward.

B. Background

4. Over the past year the Statistics Department's (STA) work on SWFs has been channeled through the wider IMF involvement in the establishment and work of the International Working Group of Sovereign Wealth Funds (IWG).

5. Responding to calls by the International Monetary and Financial Committee (IMFC) in October 2007 and in April 2008, the IWG was formally established earlier this year to present by October 2008 a set of SWF principles that properly reflects their investment practices and objectives. It is comprised of representatives from 26 IMF member countries,[1] with the IMF acting as the secretariat to the IWG, facilitating and coordinating the IWG's work.

6. The IWG's work was aimed at agreeing on a common set of voluntary principles for SWFs, drawing on the existing body of principles and practices that have been developed internationally over recent years,[2] to help maintain the free flow of cross-border investment and open and stable financial systems. On October 11 2008 the IWG presented the Santiago

---

[1] IWG member countries are: Australia, Azerbaijan, Bahrain, Botswana, Canada, Chile, China, Equatorial Guinea, Iran, Ireland, Korea, Kuwait, Libya, Mexico, New Zealand, Norway, Qatar, Russia, Singapore, Timor-Leste, Trinidad & Tobago, the United Arab Emirates, and the United States. Permanent observers of the IWG are: Oman, Saudi Arabia, Vietnam, OECD, and the World Bank.

[2] Such as the *Guidelines for Foreign Exchange Reserves Management*, and *Code of Good Practices on Fiscal Transparency*.

Principles to the IMFC and published them on its website ─ http://www.iwg-swf.org/index.htm The principles are a product of the IWG, and not the IMF, and they reflect the diversity of SWFs' objectives, structures, and institutional settings. The IMFC welcomed the development of the Santiago Principles by the IWG, and the intention to consider establishing a Standing Group to keep the Principles under review and explore the scope for collecting and disseminating aggregate information on SWF operations.

C. Survey of SWFs

7. To support the work of the IWG, a survey of SWFs was organized and conducted in the first half of 2008. The results of the survey, to which 20 members of the IWG responded, were shown to and discussed by the IWG, and published on the IWG website in early September (see Appendix I). It immediately attracted media attention.

8. As background, the Committee's support last year of work by STA to confirm the understanding of member countries' treatment of SWFs in their various external statistics datasets, raised the idea of a survey. This idea was shared by our Monetary and Capital Markets Department (MCM), the lead department within the Fund on SWFs, along with our Strategy and Policy Review Department. Hence the survey was jointly conducted by STA/MCM.

9. With regard to macroeconomic datasets, a majority of SWFs that responded to the survey reported that they make their data available to compilers of macroeconomic statistics. Some of the responses elaborate on the level of detail in terms of sectorization, functional classification, and instrument breakdown, while the majority of SWFs that responded explicitly mentioned that their data provision is included in the Balance of Payments Statistics, International Investment Position, and/or Government Finance Statistics (page 12).

10. The SWFs that participated in the survey did so on the understanding that individual SWF information would not be revealed. Indeed, as with other such confidential surveys, the information on individual SWFs was known only by a very small group of individuals. As a consequence, we have not yet updated Table 1 of last year's BOPCOM paper on SWFs, which set out the reporting approach in the external accounts as known by the Fund.

D. Santiago Principles

11. The Santiago Principles are available at http://www.iwg-swf.org. The document is not attached to this paper because of its length - close to 80 pages.

12. Following an introduction and an explanation of objective and purpose, the document is divided into three parts.

- Part I lists 24 principles (Generally Accepted Principles and Practices, so-called GAPPs);

- Part II provides a short commentary to each GAPP and clusters them into three categories: Legal Framework, Objectives and Coordination with Macroeconomic Policies (GAPP 1 to 5); Institutional Framework and Governance Structure (GAPP 6 – 17); and Investment and Risk Management Framework (GAPP 18-24)

- Part III covers appendices and references. Included in this Part is the definition and its explanation, and most helpfully, a description of individual SWFs.

13. Overall, the development of the Santiago Principles is recognized as a significant step forward: SWFs across mature, emerging, and developing countries have produced a comprehensive collective framework in a very short time period. Nonetheless, as the IWG itself recognizes, there are several areas that could benefit from further study and work. And so, over time, the Santiago Principles could be further expanded and strengthened.

14. There are several aspects of the Santiago Principles of relevance to the Committee's work. These include the definition of SWFs, the principle covering macreconomic data provision, the reference to reserves assets, and the on-going work of the IWG, particularly the possibility of aggregation of information.

Definition

15. The Santiago Principles include a definition of SWFs. The definition is:

"SWFs are defined as special purpose investment funds or arrangements that are owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies that include investing in foreign financial assets. The SWFs are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports."

16. The definition is provided initially in the statement of objective and purpose and then again in Part III, which explains in more detail the key elements of the definition: ownership, investments, purposes and objectives, and their funding. This extract for the Santiago Principles is attached as Appendix II.

17. The definition and its structure may look familiar to BOPCOM members. This is not surprising as the starting point was the relevant text in the draft *BPM6*. Subsequently we have replaced the definition in *BPM6* with the definition agreed by the IWG.

Supply of Data for Inclusion in Macroeconomic Statistics

18. The fifth principle (GAPP 5) covers macroeconomic statistics. Verbatim, it reads:

"*Principle*

The relevant statistical data pertaining to the SWF should be reported on a timely basis to the owner, or as otherwise required, for inclusion where appropriate in macroeconomic data sets.

Explanation and commentary

Policymakers in general rely on macro-economic datasets that are accurately compiled and disseminated by the national agencies (such as the National Statistical Office, and the statistics departments in the central bank and Ministry of Finance). The absence of economic data in national macroeconomic datasets of national accounts, fiscal, monetary, and external sector statistics, can hinder economic analysis and potentially mislead data users. The importance of SWFs underlines the need for their activities to be captured in relevant macroeconomic datasets. Cooperation in data reporting primarily involves the owner, or—depending on national arrangement—the SWF, transmitting timely SWF data of good quality and relevant scope to the appropriate national agencies, using modalities of data transmission agreed with those national agencies. The data should be treated with customary confidentiality by the national agencies as set out in the Statistical Law/regulation(s). Adding a description of key features of the statistics supplied (so-called metadata) facilitates its correct interpretation."

19. In drafting the principle, the SWFs recognized the importance of macroeconomic data but wanted to be clear that their role is in the provision of data that can be incorporated into macroeconomic data. Understandably, in their view it is up to the national statistical agencies to include SWF data in the macroeconomic datasets and determine statistical dissemination policies.

20. Also, during the discussions it became clear that the institutional arrangements among SWFs differ such that the modalities of data supply can differ: that is in some cases the SWF supplies data to the owner that in turn provides the data to the national statistics offices, particularly in cases where the SWF is not a separate legal entity or where the SWF is owned by a subnational government; and in other cases the SWF supplies the data direct to the national statistics office. The Santiago Principles reflect these two different approaches to institutional arrangements.

Reserves

21. GAPP 4.1 covers the source of SWF funding. In the commentary to this principle, a sentence is included on reserves: "The extent to which the SWF's assets are also classified as international reserves should be clarified."

22. This is a helpful sentence towards generating a greater understanding of what is included in reserve assets, and complements the supplementary item in *BPM6* that allows for the voluntary public disclosure of SWFs' foreign assets not included in reserves.

On-going work of the IWG: Aggregate Information

23. Looking ahead, the IWG has agreed to explore the establishment of a standing group of SWFs. There are indications that the group will seek a continuation of Fund support as a secretariat for the standing group.

24. Inter alia, the IWG foresees that this new group could examine ways through which aggregated information on SWF operations could be periodically collected and made available and explained. The aggregate survey discussed above is one example of the type of aggregated information that could be produced. A clearer picture of what is intended could become available once the standing group is established and meets.

E. Looking ahead

25. The progress made by the IWG since last year's Committee meeting in developing good practices and principles for SWFs has been impressive. From the statistical viewpoint, the need for data to be supplied for inclusion in macroeconomic datasets has been recognized, as has the need to clarify the extent to which SWF assets are included in reserves. Combined with the work on the definition, the discussion in *BPM6* of the conceptual treatment of SWFs, and the *BPM6* voluntary item on SWF assets outside of reserves, a coherent framework for SWF reporting within macroeconomic statistics has been established.

26. Also, the Fund has publicly recognized the importance it attaches to the inclusion of SWF activities in economic datasets. The day after the Santiago Principles were provisionally agreed, Mr. Lipsky, First Deputy Managing Director of the IMF, made a presentation at a seminar organized by Chile's Ministry of Finance to share some observations on the economic role and policy significance of SWFs. He covered SWF's expanding significance in a global economic and financial context, their role in attaining the goals of their sponsoring governments, and their international importance. The speech is available at https://www.imf.org/external/np/speeches/2008/090308.htm.

27. In the speech, in the context of integration into the sponsoring government's economic policy framework, he emphasized the critical importance of adequate information being reported to the relevant agencies, and that "accurate data are included in national accounts, as well as monetary, government finance, and external sector statistics."

28. Given the commitment of SWFs as set out in the Santiago Principles, with regard to macroeconomic statistics, the challenge now turns to national statistical agencies. Further, the issue arises as to what role the Committee might play in encouraging this process. On this we would welcome the views of Committee members.

F. Questions for the Committee

What comments do Committee members have on the work of the IWG and its outcome (Santiago Principles)?

For those Committee members in countries with SWFs, what is the experience in receiving relevant and timely data from SWFs to be included in macroeconomic datasets?

What views do Committee members have with regard to encouraging countries with SWFs to include the data of relevant scope in the appropriate macroeconomic datasets?

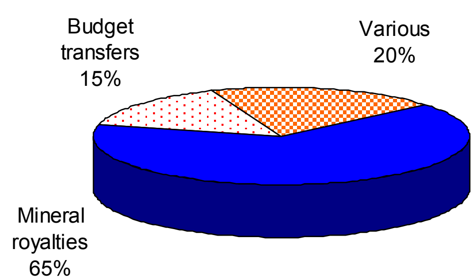
Appendix I: Sovereign Wealth Funds: Current Institutional and Operational Practices

The International Working Group of Sovereign Wealth Funds (IWG) was established on April 30, 2008, to identify and draft a set of principles that properly reflect their investment practices and objectives.[3] *As part of this initiative, certain IWG members completed a short survey of their current institutional and operational practices. The SWF survey, which was conducted by staff of the International Monetary Fund (IMF), solicited responses on a voluntary and confidential basis from members of the IWG.*[4] *The IWG used the responses as background information and input in the preparation of the Generally Accepted Principles and Practices for SWFs (GAPP). The IWG agreed in its meeting in Santiago, Chile, held on September 1–2, 2008, to publish the information as a step toward improving the understanding of their current practices. A summary of the survey responses is provided below under three broad headings: (i) Legal Framework, Objectives and Macroeconomic Linkages; (ii) Institutional Framework and Governance Structure; and (iii) Investment Policies and Risk Management Frameworks. It is based on responses received by end-July 2008.*

A. Background

This summary of current SWF practices is based on responses to the SWF survey from 20 members of the IWG. The respondents are a diverse group, coming from four different continents, and are from countries having annual per capita incomes that vary from under US$1,000 to over US$80,000. The SWFs included in this analysis have been operating for various lengths of time; some were established as far back as the early 1970s, others as recently as a year ago.

Primary Source of Funds for SWFs
(% respondents)



Among the respondents, the majority of SWFs are funded out of mineral royalties (principally oil), while the remainder are funded from fiscal surpluses, as well as other sources including foreign exchange reserves and returns on fund investments. In a few cases, divestment proceeds and borrowing from markets have also played a role in asset accumulation.

---

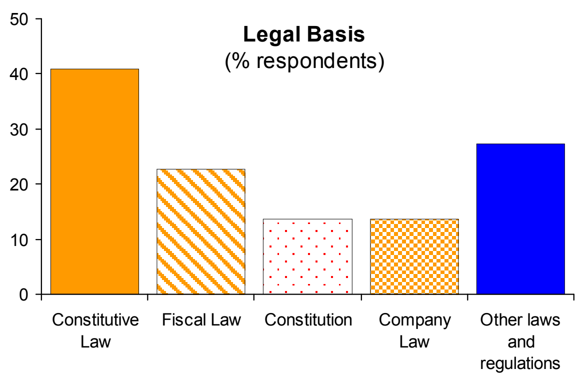
[3] For further information on the IWG see http://www.iwg-swf.org/index.htm.

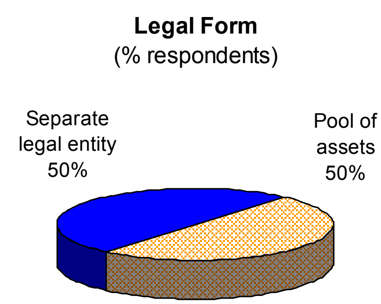
[4] This note has been prepared by the IWG Secretariat in collaboration with the members of the IWG. The authors are: Cornelia Hammer, Peter Kunzel, and Iva Petrova of the IMF. For any questions on the survey, please contact Udaibir S. Das, Division Chief, Sovereign Asset and Liability Management Division, Monetary and Capital Markets Department, IMF (udas@imf.org).

B. Legal Framework, Objectives, and Macroeconomic Linkages

Legal basis and form

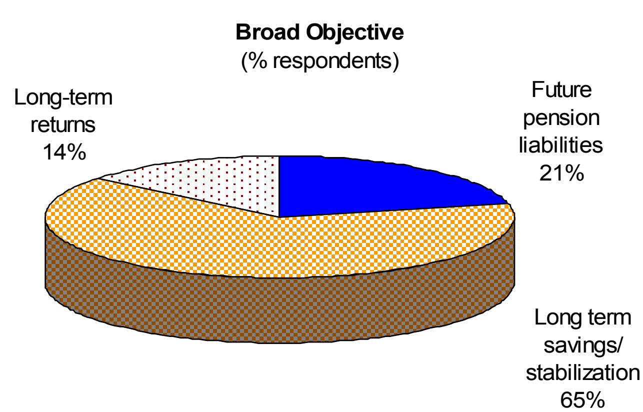
The legal basis and form in which SWFs are established varies from country to country. SWFs are often underpinned by specific legislation and, in a few cases, by the Constitution. Half of the respondents indicate that they are established as legal entities separate from the state or the central bank, whereas the rest are not separate legal entities (pool of assets). SWFs falling under the former category either have a legal personality established under a specific constitutive law, or are a private corporation established under company law. SWFs falling within the latter category are usually controlled by the Ministry of Finance and operationally managed by the central bank or a statutory management agency. While many of these SWFs are also established by specific constitutive laws, some are established by general fiscal (budget or fiscal responsibility) laws, and one is established under the central bank law.





Typically, SWFs' constitutive legislation is publicly available. Constitutive laws, company laws, and budget laws under which SWFs are set up are publicly disclosed. One SWF that is established as a separate legal entity also publishes its charter of incorporation. In some cases where the SWFs are established as pools of assets, the management agreement between the ministry of finance and the central bank are publicly disclosed.

Objectives and macroeconomic linkages



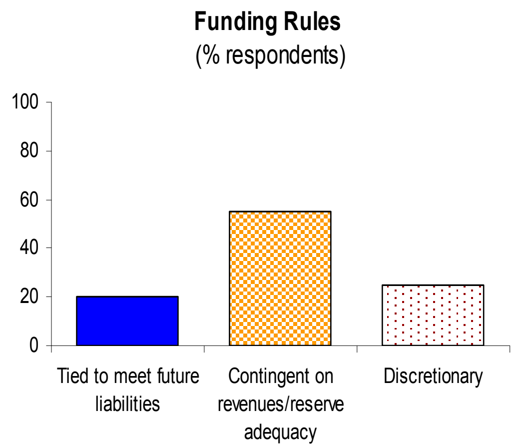
The policy objectives of the SWFs are in part tied to the broad nature of their liabilities. SWF Survey respondents generally indicate that they do not have direct liabilities, though some SWFs explicitly aim to cover expected future pension expenditures. Those SWFs without explicit future pension expenditures indicate that their fund is set up either to provide savings for future generations or fiscal stabilization (or both) or as reserve investment corporations. SWFs with future expected liabilities indicate that their primary objective is to cover the cost of these future expenditures. SWFs, and in particular those that act as legally-separate private corporations (see section below), also point out that their primary objective is to deliver long-term financial returns and effective management of entrusted assets. As the policy objectives of the SWFs are typically stated in their constitutive legislation, those objectives are publicly disclosed in most cases.

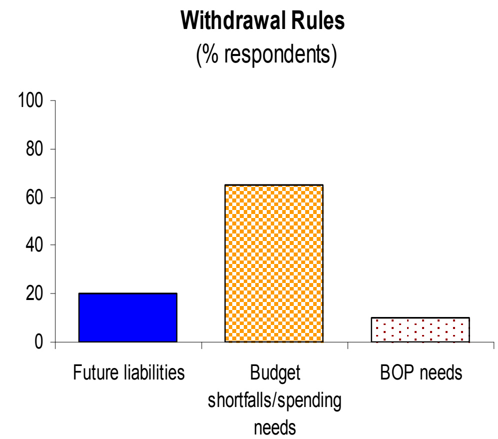
SWFs generally indicate that they do not engage directly in macroeconomic policies, but with two exceptions: (i) transfers to the budget for exceptional and targeted needs, and (ii) the drawdown of funds for transfer to the central bank in case of exceptional balance of payments or monetary policy needs. In one case, a separate short-term fund was set aside for such purposes.

Funding and withdrawal rules

Funding and withdrawal rules are specific to the type of SWF and set out in legislation. Thus, pension reserve funds (without explicit liabilities) typically have specific funding rules tied to meet future pension expenditure (for instance, a minimum amount is required per year to meet estimated future pension expenditure targets). Similarly, withdrawal rules for these funds take into account future estimated obligations. Except under exceptional conditions, funds cannot be withdrawn and require, for instance, targeted levels of the fund to be exceeded as well as Parliamentary approval.

Funding and withdrawal rules of other SWFs are usually tied to the source of the funds. For instance, *fiscal stabilization funds* are typically funded from revenue contingent deposit rules (i.e., exceeding a target), and withdrawal rules are typically crafted to meet specific budget deficits (i.e., in the event of a revenue shortfall) or funding needs, though not all SWFs specify what these may be. *Reserve investment corporations* are typically funded in relation to reserve adequacy requirements, and some funds have established asset trust contracts with sponsors that change periodically. Other differences in the rules exist: some keep capital and returns while others pay out targeted annual dividends to the owner (over fund targeted ceilings, taking into consideration operational expenses, etc.); some can invest directly in specific local investment projects, though respondents note that such transactions are reflected in the budget and are compliant with local and international government statistical rules (where indicated).

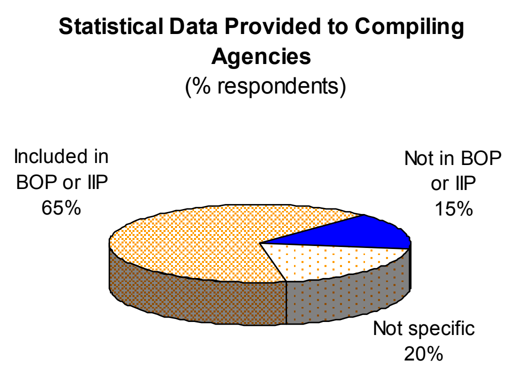




Statistics compilation and reporting

Respondents indicate that they produce economic and financial data on a regular basis. While some SWFs make information directly available to the public (for instance through annual and/or quarterly reports), others provide statistical data, such as on the size of the portfolio, its operation and performance indicators, only to the relevant national agencies. This largely depends on whether the fund is a separate legal entity (see section on integrity of operations below).

A majority of SWFs make their data available to compilers of macroeconomic statistics.[5] Some of the responses elaborate on the level of detail in terms of sectorization, functional classification, and instrument breakdown, while the majority of these funds explicitly mention that their data provision is included in the Balance of Payments Statistics (BOP), International Investment Position (IIP), and/or Government Finance Statistics (GFS).



Some respondents mention that SWF data included in their BOP and IIP statistics cannot be distinguished because they have been consolidated with other items. This is in line with the current statistical methodological framework which does not provide for a separate recording of the external assets of SWFs. The draft version of the new IMF Manual on Balance of Payments and IIP Statistics (*BPM6*) allows for the voluntary public disclosure of SWFs' foreign assets not included in reserves. It also advises on the sectoral allocation of

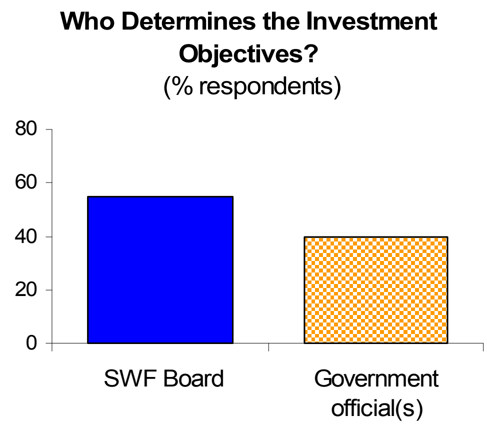
[5] In some cases, the respondents are not specific on the regular provision of SWF data to compiling agencies.

these government funds, depending on their institutional setting, and their functional classification, such as reserve, portfolio, direct investment and/or other investment.

C. Institutional Framework and Governance Structure

Institutional framework

Institutional arrangements differ from one country to another. Investment policies, management and operational decisions are often centralized within the SWF or the central bank through a Board of Directors or Steering Committee. However, this is not always the case and responsibilities can be more dispersed. For instance, in some cases where the SWF is not a separate legal entity the Minister of Finance or another official may be responsible for setting the specific investment objectives and benchmarks (often with the help of an advisory committee). In other cases—e.g., where the SWF is a separate legal entity—the high ranking official will be responsible for making investment decisions directly as a member of the governing body. Lines of reporting vary as well—SWFs report either to a supervisory council, the Minister of Finance or an elected official (President or Governor), or directly to Parliament.



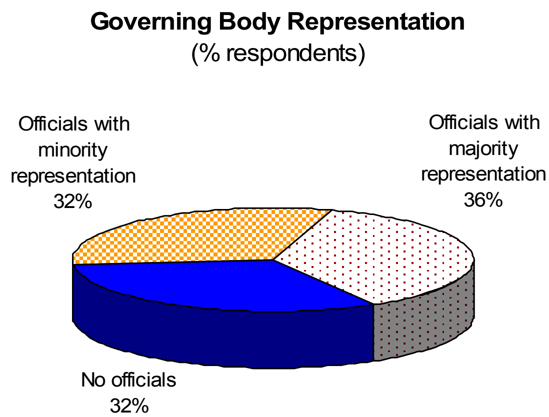
Many respondents indicate that the respective institutional framework aims to provide the SWF with operational independence, while ensuring its accountability to the government and the public. In many cases this balance is achieved by establishing a separate legal entity or by entrusting management to the central bank, while requiring disclosure of audited financial reports and regular reporting to the Ministry of Finance and Parliament. Some respondents also note that ministerial directions to the SWF need to be reported to Parliament.

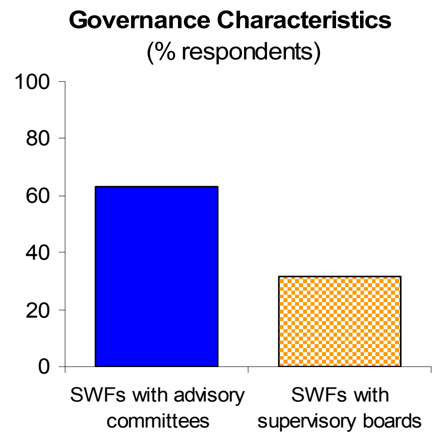
Where the SWF is a separate legal entity, operational independence is also typically embedded in the rules and procedures for appointment and removal of the members of the governing body. Though appointments to the governing body of SWFs (legally separate or otherwise) are frequently made by the Minister of Finance or other elected government official, these appointments are typically of long duration (5 years or more), and often include limits on the number of seats for government officials.[6] Removal from the governing

[6] While some SWFs indicate that they have limits on the number of government officials in the governing body, others do not have such limits. In cases where there are restrictions on government representatives in the

(continued)

body can take place only under specified special circumstances, namely, if a member is incapable of continuing to perform the required function for health reasons or if convicted of an indictable offence. For those respondents that answered the survey question specifically, the rules for appointment and removal of members of the governing body are established by legislation. Where the SWF is not a separate legal entity, the governing body may comprise only government officials. In such cases, operational independence is sought through the delegation of responsibility for the SWF's operational management to the central bank or a statutory management agency.





In cases where SWFs are established as separate legal entities, they are managed by a Board of Directors, which typically comprises five to nine members. Board members are selected on the basis of their expertise in investment management, corporate governance, finance and economics. The Board is chaired by a Chief Executive Officer (CEO), who is either selected externally (i.e., by the Minister of Finance) or by the Board. Some SWFs have advisory committees to assist and advise the Board in such areas as investment policies, audit and risk functions, corporate operations (including employee and remuneration policies), and management performance. Some SWFs also have a Supervisory Board or Committee responsible for control and oversight purposes.

The internal governance structure of many SWFs—particularly those that are established as separate legal entities—is similar to the typical structure of private corporations. The head of the SWF is responsible for executing the assigned mandate (i.e., implement and in many cases develop the investment policies) and for the employment and management of staff. The SWF-head typically has a cadre of subordinate executives with specific functional responsibilities (i.e., a Chief Operating Officer, Chief Financial Officer, and a Chief Investment Officer). The structure then branches out into various functional

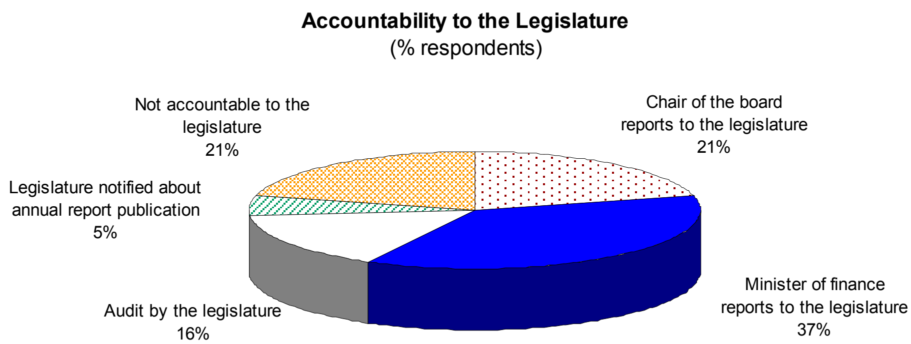
---

governing body, the number of seats is low (minority). In some cases there is no official representation in the governing body at all.

clusters, which are headed by managers. In the case of SWFs that are established as pools of assets without separate legal personality the agencies responsible for the SWFs' operational management may have varying structures.

Accountability

Accountability to the legislature is vested in the entity that owns or manages the SWF. In those cases where the **SWF is not a separate legal entity**, the Ministry of Finance reports to Parliament on the activities of the fund. The report to Parliament—which is commonly presented annually but in one case is provided quarterly—contains audited financial statements of the fund either separately or as part of the government financial statements, or the audited financial statements of the managing entity.



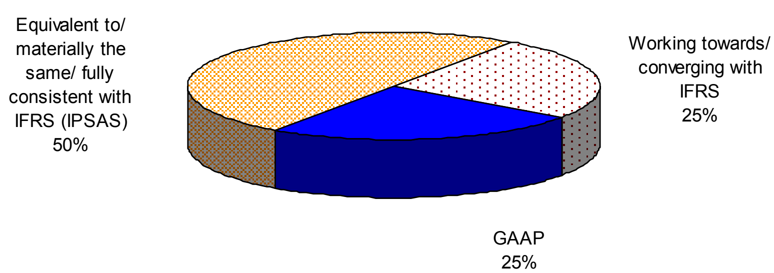
Parliaments can exercise varying levels of scrutiny over SWFs that are managed by a legal entity separate from the Ministry of Finance or the central bank. In most cases, the report of the SWF, including its audited financial statements, is submitted to Parliament or a parliamentary committee annually or upon request by the committee. The Boards of these SWFs are typically required to prepare annual business plans, against which they are held accountable in the annual reports. In one case, a designated parliamentary committee approves the business plan and the annual report and communicates to the public on the activities of the SWF and its performance results.

In cases where the SWFs are separate legal entities, another layer of accountability may be added by the Minister of Finance. In these cases, the accounts of the SWF may be fully consolidated with the government's accounts and the Minister of Finance is responsible for the investments of the fund. The Minister of Finance may hold the Board of the SWF accountable for the SWF's statutory objectives and investment mandate, or the consistency of the Board's investment strategy with the government's investment mandate. If satisfactory performance in regard to these objectives and mandate is lacking, the Minister of Finance may terminate the appointment of the Board members.

Where the SWF operates as a corporation under general company law, it is typically accountable to its shareholder—the government represented by the Minister of Finance—for its performance. The Minister of Finance ensures that the Board is competent to oversee the activities of the SWF, but the government operates at arm's length and does not get involved in the business and investment decisions of the SWF. The SWF typically publishes an annual report and maintains a website to inform the public.

All SWFs prepare and present their financial statements according to a prescribed set of accounting standards. Some SWFs state that their financial statements are in full accordance with the IFRS. Others indicate that they apply accounting standards which they consider "equivalent to" or "materially" the same as the IFRS, or refer to the preparation of their financial statements in line with "International Public Sector Accounting Standards" (IPSAS), which take account of the characteristic features of the public sector. Another group indicates that they are in the process of converging towards full IFRS compliance. Finally, some SWFs apply their own national, generally accepted accounting principles (national GAAP) or national Financial Reporting Standards, and three SWFs specifically mention market-based measurement. A few SWFs describe minor exceptions to the accounting standards that are in place in terms of presenting or publishing the data. Some SWFs emphasize that the responsibility and requirement to prepare and accurately present their financial statements are constituted by law, setting the legal requirements for the preparation and presentation of the financial report according to appropriate accounting policies and free from material misstatements.

Applicable Accounting Standards
(% respondents)



SWFs' financial statements are subject to the professional judgment of internal and appointed external auditing entities, although with varying institutional settings. Some SWFs explain that the financial statements are audited according to audit standards that are almost identical to, or are currently undergoing a harmonization toward, internationally recognized audit standards. While auditing focuses largely on financial information, the process in some SWFs also involves an evaluation of management activities, e.g., in terms of assessing the effectiveness and efficacy of risk management tools, as well as an assessment of the efficiency of internal control systems.

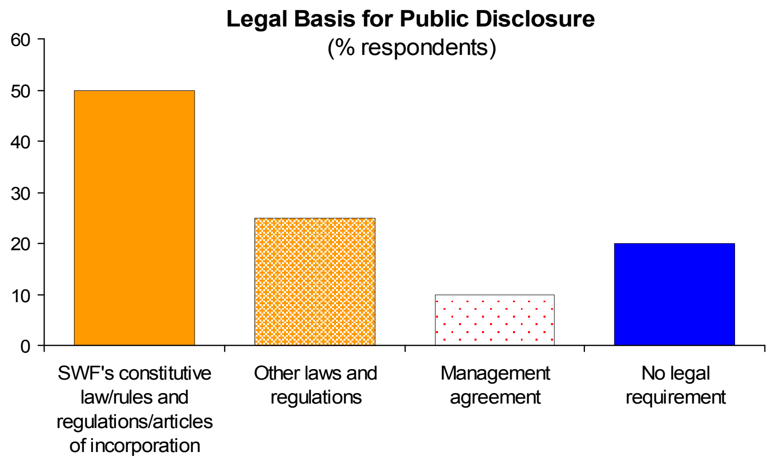
All respondents indicate that they have internal audit arrangements in place. In some SWFs, internal auditing is undertaken by independent auditors, such as accounting firms or temporarily appointed statutory auditors. Other SWFs have established internal audit divisions to strengthen in-house commitments to internal control and supervision arrangements in covering various business areas of the SWF. Internal auditors or internal control units assess and review the funds' activities in accordance with adopted legislation; oversee compliance with the respective investment guidelines in terms of profitability and risk exposure; provide regular reports of their findings; and make recommendations to internal bodies, often referred to as internal Audit Committees in charge of oversight and monitoring compliance and internal audit functions. When the SWF has no formal internal audit entity in place, the auditing function may be assigned to another department within the SWF that has duties similar to the internal audit functions.

External audits are in most cases performed by independent, internationally recognized accounting firms. Few SWFs have their accounts audited by Auditor Generals, another independent government agency or the Ministry of Finance itself. Audit procedures include an evaluation of the fund's administration, a review of the Board's judgments and decisions, and an assessment of financial and management controls. SWFs put emphasis on the temporary appointment of the external auditing entity to ensure independence, regularity of the audit (usually annually), the availability of audited reports to the public and compliance with the International Auditing Standards.

Integrity of operations

In general, SWFs share common standards governing the conduct of personal financial affairs and have similar rules to prevent exploitation or misuse of funds by members of the Board, management and staff. These are either set out in separate legislation and/or codes of ethics, codes of conduct and manuals adopted by the SWFs that address insider dealing, conflicts of interest, disclosure policies, systems of monitoring and detecting unethical behavior and fraud, and mechanisms for properly addressing and managing instances of fraud. While specific standards within these broad categories differ from one SWF to the other, some common practices reported by SWF respondents include requiring financial reporting and disclosure of investments on a regular basis, prohibiting the acceptance of gifts (other than meals or token gifts), and having a compliance officer to ensure compliance with applicable laws, regulations and standards.

Legislation governing SWFs usually requires public disclosure of information about their institutional structure and operations. Most commonly, the legal and the institutional framework of the SWFs is publicly disclosed, but other information may not be provided. More than 50 percent of the respondents indicate that they publish annual audited financial statements, at least a summary of their asset allocation—in some cases even the actual portfolio—and performance information. Furthermore, a significant number of the respondents publish unaudited statements quarterly or monthly, and one SWF publishes the unaudited value of the fund daily.



Public disclosure by SWFs that are not separate legal entities varies significantly. The assets, revenues, and expenses are typically published by the agency responsible for the management of the SWF. One SWF publishes extensive information describing the objectives of the fund, its institutional framework, agency arrangements, investment policy (including a broad discussion of the implementation of ethical guidelines), risk management framework, audited financial statements and accounting policies, actual portfolio composition (including a complete list of all assets held by the fund and the manner in which it has exercised its voting rights), and performance data.

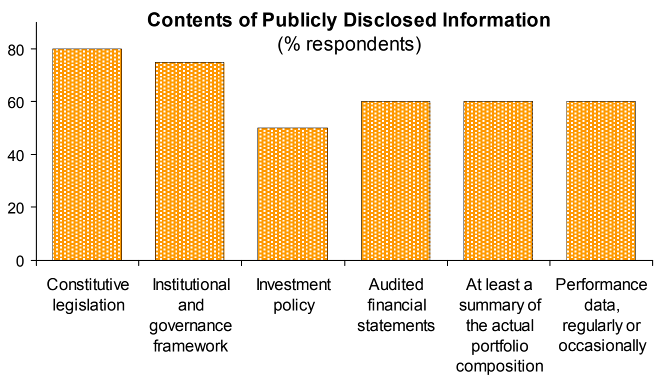
SWFs that are established as separate legal entities are typically required to publish detailed annual reports, including information about their objectives and legislative basis, institutional arrangements and governance structure, investment policies and risk management framework, audited financial statements, and performance data. The information is disclosed through the internet or by the virtue of disclosure of information submitted to Parliament.

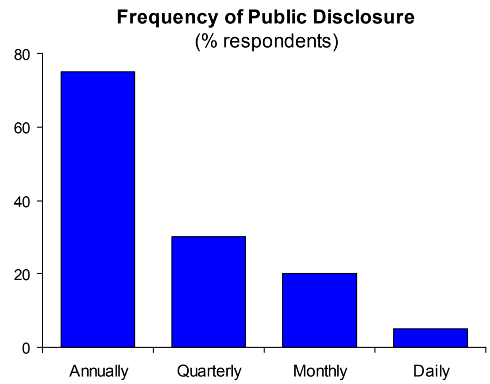
SWFs that are separate legal entities are not generally required to publish their actual portfolio information. However, in one case the SWF is required to disclose investment information verifying that its investment policy is consistent with the *United Nations Principles for Responsible Investment*.[7] On the other hand, a number of SWFs strive for greater transparency beyond the statutory obligations. These SWFs publish the current asset allocation—including for example, real estate, bonds, and stock holdings—Board minutes,

---

[7] Institutional investors who have adopted these principles consider that environmental, social, and corporate governance issues can affect the performance of investment portfolios and the application of the principles can help better align investors with broader objectives of society.

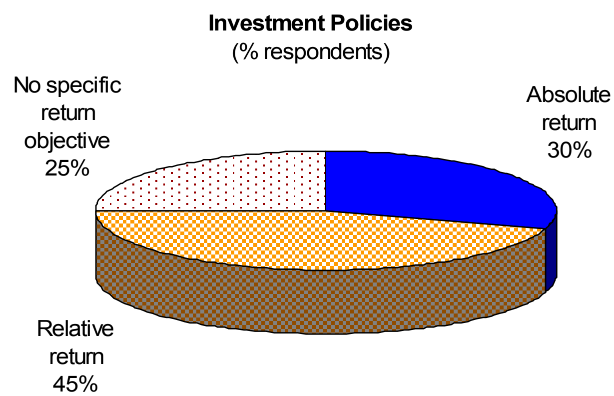
and unaudited statements at higher frequency than required by the statute for audited statements.





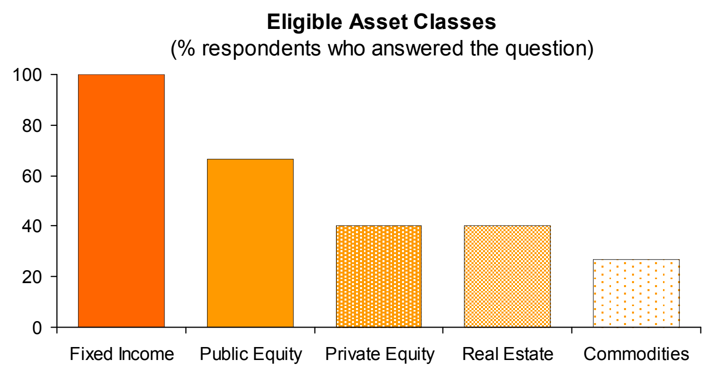
D. Investment Policies and Risk Management Frameworks

The majority of respondents indicate that they have specific investment objectives. While a number of funds maximize returns relative to a benchmark, others have absolute return objectives, but the risk constraint plays an important role as the feasible set of returns changes over time (after the objective has been set). The investment objectives are either explicitly stated by the owner of the funds (i.e., the government)—especially when the SWF is not a separate legal entity—or by the manager of the funds when the owner or applicable law formulates more general investment objectives. Several respondents indicate that they do not have specific return objectives aside from a general objective (i.e., of seeking long-term financial returns). About half of the respondents indicate that they disclose publicly the specific investment objectives of their SWFs.



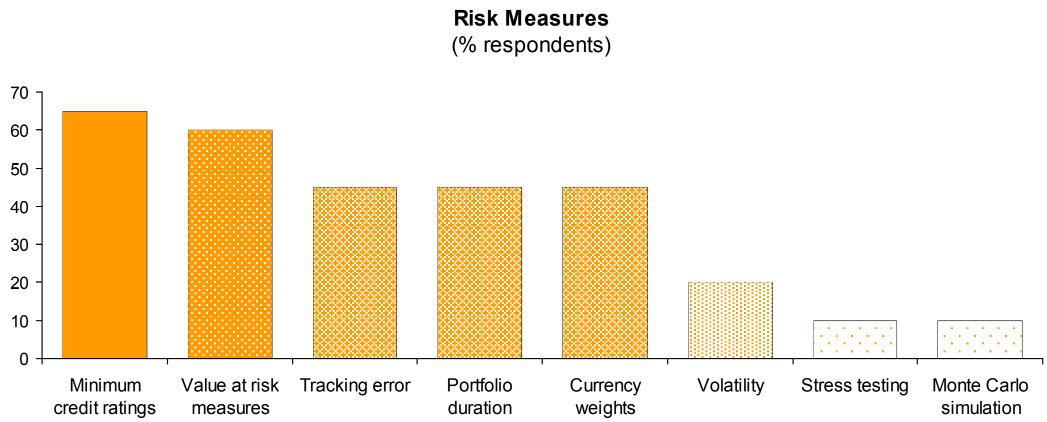
Some SWFs indicate that they use an asset approach in determining their investment strategy, and one SWF explicitly states that it uses an asset-liability approach. The investment strategy is typically derived using a mean variance asset allocation model. In some cases, the return objective and risk parameters are formulated relative to a benchmark based on a market index (see above). Asset class and regional weights are also set against a benchmark. Most respondents indicate that the asset allocation has a long-term focus but is reviewed regularly—every one to two years. Performance is also reviewed regularly, in many cases daily, and is assessed relative to the index. Portfolio rebalancing is based on the maximum tracking error deviation and is done at regular time intervals (weekly, bi-weekly, monthly, or quarterly), but may also be triggered by large market movements.

Investment strategies vary from traditional to more advanced. SWFs that are not separate legal entities have relatively traditional asset allocations, mostly limited to highly rated government securities; only a few are investing in equity and taking on more credit risk. Other SWFs use more alternative asset classes, with benchmarks including 40–70 percent equity, 4–10 percent private equity funds, 13–40 percent fixed income, 2–5 percent infrastructure, 2–5 percent commodities, and 8–10 percent real estate. One SWF acknowledges that it has the option of taking concentrated risks and is open at all times to increase, reduce, or divest its holdings.

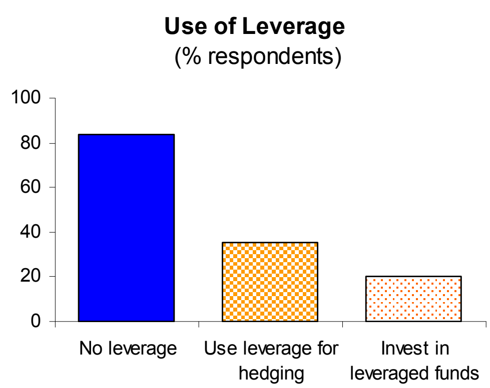


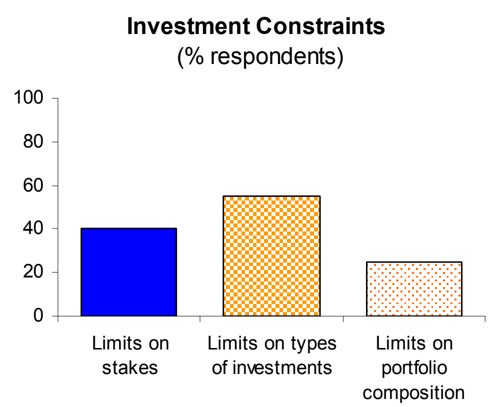
Risk objectives are typically determined by the owner or the governing body of the SWF. While broad principles are generally established within the law or by the owner of the funds, more specific risk management objectives are typically laid out by the SWF's managers. SWFs indicate that these are usually set as tracking error limits or risk bands relative to a benchmark index for tactical management. About half of the survey respondents report that they disclose publicly elements of the risk management policy of their SWFs.

The most common risk measures and methods to manage financial risks are credit ratings, value-at-risk models, tracking error, duration, and currency weights. Credit risk is usually constrained by limits on exposure to different tiers of credit and issuers. Liquidity risk is mitigated by investing primarily in securities traded in recognized exchanges and requirements for portfolio diversification of the asset managers. Currency risk is controlled by a foreign currency hedging policy for the portfolio and limits on currency exposure relative to the benchmark for individual asset managers. Some SWFs indicate that overall risk levels are subject to stress testing.

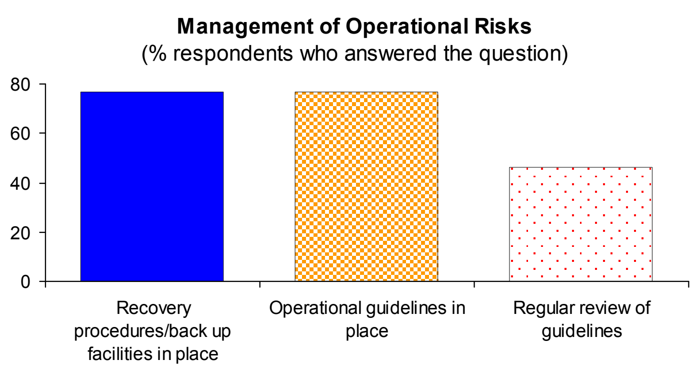


In addition to tactical risk limits, SWFs typically observe general constraints on investment classes and instruments. Most SWF respondents note that they are not allowed to borrow or use leverage. Several SWFs point out that they invest in certain asset classes that use leverage (e.g., private equity and multi-strategy funds) or employ derivatives for the purpose of protecting the value or return of their investments. In addition, many SWFs have established limits on stakes that they can hold in companies, the types of investment they can hold (e.g., investment grade assets only), and/or on other characteristics of their portfolio (e.g., currency or country).





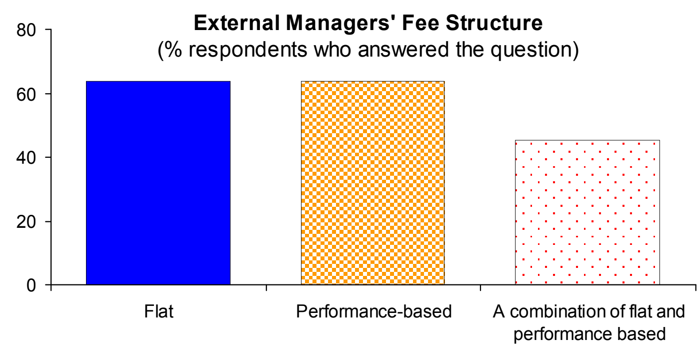
Several SWFs point out that operational risk is controlled through separation of responsibilities, including front, middle, and back offices. SWFs also mitigate operational risk through the implementation of codes of conduct and policies on conflict of interest for staff and the governing body, regular reconciliation of accounts, and



regular and active audits. Several SWFs note that they use back-up facilities, global custodian services, and business continuity plans, as well as regularly (annually) reviewed operating manuals, to mitigate operating failures. One SWF also monitors operational risk with early warning indicators and by assigning direct responsibility for operational risk monitoring to line managers. Finally, some SWFs note the use of workflow automation and frequent—even daily—reports by the middle office to management to ensure timely communication and early warning of operational risks.

The proportion of assets managed by external asset managers varies widely across the respondents in line with the adopted investment strategies. Only two of the responding SWFs do not use external managers at all, although one of them is actively considering this possibility. In contrast, some SWFs have assigned most or all of their assets to external asset managers. External managers are used in cases where the managing agency does not have sufficient expertise in managing specific assets, or where it is not cost-effective to manage them in-house due to the external mangers' economies of scale and extensive research capabilities. SWFs indicate that they mandate the external managers with both active and passive management, while only passive management remains in-house.

External managers are typically approved by the Board of the SWF. The evaluation of the external managers is based on the approved investment strategy, is considered an investment decision, and is subject to standard procedures. Although performance appears to be the main basis for appointment and removal of external managers, some SWFs indicate that the organization, the personnel team, and the investment philosophy of the external managers are also considered important factors. Fees could be flat, performance-based, or a combination of both. In some cases, an external manager policy is in place, but is not publicly available. Some SWFs publish details about their external managers. Consultants are not commonly used to assist in the selection process, except by some smaller SWFs or for specific advice in specialized areas.



E. Other Information

About a third of the respondents are currently in the process of reviewing or initiating changes in their organizational structure (governance, staffing) or in their existing strategies (investment policy). Some SWFs have been drawing on the assessment and recommendations provided by designated advisory commissions or by private advisory service companies entrusted with the evaluation of the funds' organizational structure and operational procedures. In this respect, a number of SWFs are considering requesting changes in the relevant legal framework, so as to better align it with operational and other requirements. A number of funds also mention the value added that expertise from external managers can provide by helping to engage in more active asset management with the objective of achieving higher returns and at the same time improving risk diversification. This is expected to be achieved by expanding the benchmark, broadening the investment range, for instance by investing a portion of the Fund in real estate, and in general through opening the fund to more asset classes, and also by spreading investment activities more globally.

Appendix II: Defining Sovereign Wealth Funds in the Santiago Principles

1. SWFs are defined as follows:

2. SWFs are defined as special purpose investment funds or arrangements that are owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies that include investing in foreign financial assets. The SWFs are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports.

3. This definition excludes, inter alia, foreign currency reserve assets held by monetary authorities for the traditional balance of payments or monetary policy purposes, operations of state-owned enterprises (SOEs) in the traditional sense, government-employee pension funds, or assets managed for the benefit of individuals.

4. There are *three key elements* that define an SWF:

- **Ownership**: SWFs are *owned* by the *general government*, which includes both central government and sub-national governments.[8]

- **Investments:** The investment strategies include investments in *foreign financial assets,* so it excludes those funds that solely invest in domestic assets.

- **Purposes and Objectives:** Established by the general government for macroeconomic purposes, SWFs are created to invest government funds to achieve *financial objectives,* and (may) have liabilities that are only broadly defined, thus allowing SWFs to employ a wide range of investment strategies with a medium- to long-term timescale. SWFs are created to serve a different objective than, for example, reserve portfolios held *only* for traditional balance of payments purposes. While SWFs may include reserve assets, the intention is not to regard all reserve assets as SWFs.[9]

[8] Note that the use of the word *arrangements* as an alternative to *funds*, allows for a flexible interpretation of the legal arrangement through which the assets can be invested. SWFs vary in their institutional arrangements, and the way they are recorded in the macroeconomic accounts may differ depending on their individual circumstances. See also *Government Finance Statistics Manual*, 2001.

[9] Likewise the intention is not to exclude all assets on the books of central banks: SWFs can be on the books of central banks if they are held also for purposes other than balance of payments purposes (e.g., as intergenerational wealth transfer).

Furthermore, the reference in the definition that SWFs are "... commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports"— reflects both the traditional background to the creation of SWFs, the revenues received from mineral wealth, and the more recent approach of transferring "excess reserves."