

Dear Mr Gualtieri, dear Members of the European Parliament, dear colleagues,

I am honoured to have been invited to talk about Sovereign Wealth Funds: the relevance of this category of investors managing assets in excess of USD 7 tn is in fact undoubtable.

In my short remarks, I would like to focus on 4 main key elements that, in our experience, should be considered in order to have a better understanding of the importance and complexity of SWF and namely:

- Investment appetite and market impact
- Know-how and due diligence
- Governance and conflict of interest
- SWF as partners for long-term investments.

1. Investment appetite and market impact

SWF are typically long term investors with a rather buy and hold nature and higher risk appetite than average investors. Their investment strategies are characterised by a slow investment process in line with the long term nature of these funds; a process which reduces the volatility of the buying and selling process compared to other funds.

This characteristic can be seen as one of the greatest advantages of SWF insofar as SWF investment strategies are not driven by short term returns and therefore not usually affected by short term pricing movements.

[The evolution of capital markets in the last decades has in fact seen the increasing presence of actors whose investment strategies are evaluated on a daily basis (for funds with the calculation of the NAV-Net Asset Value) in view of the possibility by investors to divest and receive the equivalent market value in return.]

The nature of SWF is in general such that divestments occur only in specific circumstances that are not usually driven by a trading strategy: this also explains why SWF investments are often in non-liquid assets such as real estate and infrastructures.

Finally, SWF can be divided into commodity and non-commodity sourced funds; the former type represents the majority and is more exposed to potential divestment requirements to stabilise volatile income streams.

2. Know-how and due diligence

If SWF represents an important stable long-term investor from a market point of view, the question on its capacity to decide on proper and sounds investment strategies is at the core of the question of the possible systemic risk generated by their actions.

[According to the Sovereign Wealth Fund Institute, in 2015 there were 76 SWF distributed across the continents with Asia and Middle East playing the most significant role (80%). Europe plays also a significant role representing 13.11% of total assets driven by the Norway SWF which is the largest among all funds.]

In our experience with some of these funds and in particular with reference to the Middle-East funds, the due diligence process and the specific investment know-how are not very sophisticated.

For a number of SWF, the investment decisions appear to follow a bureaucratic process rather than an in-depth analysis of the assets identified for the investments.

In some cases, the SWF is mandating a third party to originate or select investments according to pre-agree principles therefore delegating partially or totally the due diligence process. [This is probably also a consequence of the conservative nature of most funds and is consistent with the focus on investments in developed countries and listed securities.]

3. Governance and conflict of interest

The area where probably more progress is needed is related to governance and transparency. In 2008, 30 funds, representing collectively 80% of assets under management, laid down the principles to promote transparency, good governance, accountability and prudent investment practices: the so-called Santiago principles.

The working group created for this purpose was then transformed into the International Forum of SWF which promotes the exchange of views on issues of common principles and facilitates an understanding of sovereign wealth funds' activities and of the Santiago principles.

Notwithstanding the adherence to the principles, though, in our experience large disparities still exist across funds in the way best practices are implemented and transparency ensured. In several cases, there is still commingling between investment decisions and sovereign interests. The policy objectives expected by SWF are not-clearly documented raising questions on the motivation of some investments as well as divestment policies.

Conditionality to investments when the asset allocation is delegated includes terms that are related to policy objectives of the sovereign rather than purely financial considerations. This is the case for example for possible required links between national companies and assets.

The lack of transparency on implicit policy objectives has important bearings for the governance of many funds and therefore to the perception that standards are not aligned to the highest level. This is probably due to the unique nature of SWF which bring together an asset management objective with a potential political aim.

The not strict governance of some of the SWF does not therefore ensure a perfect independence from own governments casting some concerns on the potential use of the large resources of these funds for reasons not directly pertaining to the investment nature of the funds.

4. SWF as partners for Long-Term investments

From what said, the nature of SWF is mixed insofar as they regroup two distinguished characteristics:

- a. A clear long-term mission with a sufficiently flexible risk absorption capacity limiting the need to invest in liquid assets
- b. A somewhat not very strong governance combined with a limited due diligence capacity and expertise

Whereas the first characteristic makes SWF ideal as partners to Long-Term investments, the second one raises questions on the appropriate modalities to effectively associate them with strategic investments.

In practice, SWF have occasionally showed interest in the possibility to invest in long-term assets originated by multilateral development banks. In certain cases, they entered into agreements whereby a fund is committed to subscribe a portion of the assets originated by a multilateral bank whenever they abide to certain conditions set at inception.

The multilateral remains the lender of record, therefore retaining full responsibility on any credit event pertaining to the invested assets exerting the decisions that are deemed most appropriate to protect the investment.

The implicit expectation is therefore that the multilateral bank, given its track record, would in general succeed to negotiate appropriate terms in

case of credit events that would reduce to a minimum any probability of losses extending to the fund its special capacity as a lender.

Such an expectation generates two possible concerns that are interlinked:

- a. Reputational and liability risk: in case of a credit event, it is not clear if the multilateral would be able to fully retain its decision capacity to negotiate terms that might not be financially optimal for the investment in view of other considerations such as social or environmental impacts. In addition, it is not clear if the conditions requested by the fund in order to allocate resources to assets originated by a multilateral could reduce the independence of the latter in its due diligence and selection process. Whereas the selection process usually includes a specific decision by the fund to accept each investment, implicitly the originating multilateral could be influenced in its selection of projects depending on the type of funding on which it can count. This can generate a certain level of reputational risk which is the greater, the more stringent the criteria;
- b. Preferential capacity to negotiate favourable terms in case of difficulties: historically, multilaterals have been able to ensure a constructive dialogue with governments and authorities in case of credit events on assets that have a significant impact, directly or indirectly, to the public administration or a country. Such a dialogue suggests that multilaterals have a preferential position which is deemed acceptable and desirable because multilaterals have limited balance sheets and therefore limited assets benefitting from this preferential capacity. But also, multilaterals are expected to support borrowers in difficult situations working closely with governments, when applicable, to find remedies over-time while preserving as much as possible the economics of the investment. In the case of a partnership or a delegation agreement which would benefit the SWF by the specific nature of multilateral originating activities, the total size of the assets that could be enjoying a better recovery status could become larger to a point that would make a proper recovery dialogue more difficult.

Conclusions

In view of these considerations, some more refined thinking is probably needed to define the appropriate modalities for an investment

partnership with SWF ensuring a full independence in the origination cycle by long-term actors such as multilaterals. Such independence would protect the multilateral from compromising on the achievement of its policy objectives as decided by its governing bodies. Additionally, such independence would be a necessary element to reduce possible reputational risk and any change in the set of incentives that inform multilateral decisions.

This would be particularly true in case of the possible channelling of SWF resources to EFSI whose independence to define appropriate modalities to achieve stated objectives of additionality and impact needs to be protected.

At the same time, a continuous dialogue with SWF, and notably with the ones that demonstrate better governance and transparency, is valuable and can help to device the appropriate modalities to associate the long-term nature of SWF with the long-term economic objectives of the initiatives such as the Investment Plan for Europe.