Beyond Santiago: status and prospects

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The rise of sovereign wealth funds as an important investor class in international finance has been a source of concern for a number of industrialised economies who feared that these funds’ investments could compromise their economic competitiveness and national security. Reacting to steps – some real, some threatened – in recipient countries to enact regulation against sovereign investment, sovereign wealth funds responded by developing their own set of “industry standards.” In October 2008, the International Working Group of Sovereign Wealth Funds published the Generally Accepted Principles and Practices (GAPP), more commonly known as the Santiago Principles. The purpose of the Santiago Principles is to identify a framework of generally accepted principles and practices that reflect appropriate governance and accountability arrangements, as well as prudent investment practices by sovereign wealth funds. Three aspects relating to the Santiago Principles warrant closer examination and will be discussed in this article: first, why did sovereign wealth funds find it necessary to develop and associate themselves with the Santiago Principles? Second, what is the status of the principles as a new approach to global financial governance? And third, how robust are the Santiago Principles and can they contribute to a stable global financial system and a free flow of capital and investments?

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Why the Santiago Principles were established

At a first glance, the reasons for the emergence of the “Santiago Principles” appear straightforward: they are a direct response to public concerns regarding the supposed threats and challenges that investments by sovereign wealth funds from emerging economies create for recipient countries. The debate over the role of sovereign wealth funds was initially fuelled by estimates suggesting that the assets under management of these funds assets had reached $3 trillion in 2007 – and could increase to $12 trillion in 2015. Soon the debate entered the mainstream public policy discourse, with commentators arguing that sovereign wealth funds would shake capitalist logic. The intensity of the debate peaked when sovereign wealth funds from emerging markets in Asia and the Middle East acquired major stakes in leading financial institutions in the winter of 2007 and 2008, causing a profound backlash in industrialised societies at a time when Western finance started to crumble.

To respond to this backlash, the International Working Group was established in April 2008 during a meeting of countries with sovereign wealth funds. Within three follow-up meetings, the International Working Group draft the Santiago Principles (named after the Chilean capital, which hosted the key meetings), which would later be made public during the meeting of the International Monetary and Financial Committee in October 2008. The principles were underpinned by four guiding objectives: (i) to help maintain a stable global financial system and free flow of capital and investment; (ii) to ensure that sovereign wealth funds comply with regulatory and disclosure requirements in the countries in which they invest; (iii) to ensure that sovereign wealth funds invest on the basis of economic and financial risk and return-related considerations; (iv) to have in place a transparent and sound governance structure that provides for adequate operational control, risk management, and accountability.

Shift economic power

The emergence of the Santiago Principles cannot, however, be fully explained and understood without reference to some of the broader trends that are changing the face of globalisation and provide us with a backdrop for the global debates concerning the future role of sovereign wealth funds in the global financial architecture. The first trend is the shift of economic power from the West to the East. The rise of sovereign wealth funds, in particular those from Middle Eastern and Asian economies, is a stark indicator of a profound transition in the global economy. Industrialised countries assume that the investment policies of emerging economies are not merely driven by an opportunistic calculus, but rather a strategic one that supports the rise of emerging economies at the expense of the industrialised world.

The second trend is a shifting balance of power from the market to the state, a trend that is being reinforced by the reactions of governments to the global financial crisis. The rise of sovereign wealth funds has demonstrated that the state is set to play a much more powerful role in the allocation of capital, a development that challenges the assumption that private investors are the most efficient and effective agents in global financial markets. Linked to that, is the notion that political motivations could be a substantial, if not guiding, element in investment decisions, since these are both taken and executed by government agencies.
Third, concerns over dealing with state-backed investors from emerging economies may have been flamed by the very term “sovereign wealth fund”. The concept of sovereignty is deeply rooted in political philosophy, and is defined as supreme authority within a territory, or alternatively, as freedom from external control. It has been, probably subconsciously, confusing for the political audience of recipient countries to see a sovereign agency of a foreign government making direct acquisitions in assets that exist within the sphere of its own jurisdiction, and in consequence challenge its own claims to sovereignty.

Finally, the rise of sovereign wealth funds as an item on the global public policy agenda cannot be sufficiently explained without highlighting the rise of the global information society. This has given tremendous leeway for non-state actors to influence the course of politics – many sovereign wealth funds from emerging economies did not anticipate the agenda-setting power of non-state actors. The restrictive approach to transparency of many sovereign investors made them an easy target for criticism. As a result, the findings of analysts and researchers based in academic institutions and think tanks, government agencies and private corporations, quickly reached media outlets that repackaged information and further shaped public perceptions of sovereign wealth funds. Consequently, claims such as that the value of assets of sovereign wealth funds could reach $12 trillion in 2015, or that the Abu Dhabi Investment Authority controls $875 billion worth in assets, have acquired a very high profile in debates concerning the rising influence of sovereign wealth funds – even if these claims or findings were not always appropriately contextualised.

**Will the principles be enough?**

The four point raised above relate to the demand for a framework that would facilitate the integration of sovereign wealth funds into the global financial architecture. Will the principles help ensure that supply meets the demand for a framework? As a starting point, the principles are based on broad participation from Asian, Middle Eastern, European, and American sovereign wealth funds, and are thereby highly inclusive. This is remarkable since these kinds of voluntary arrangements are usually supported by a constituency that is predominantly recruited from developed countries, which is increasingly detrimental to their effectiveness given the current dispersion of economic clout. As such, the Santiago Principles are indicative of an innovative approach to global governance, which seeks to integrate industrialised and emerging economies in new arrangements, in an attempt to organise collective action. This moves in parallel with arrangements like the more inclusive G20 process.

They also address the conflicting and apparently irreconcilable claims to sovereignty: the claim that the sovereign investor should be free from external control in his investment behaviour, and that the sovereign recipient country should be free to exercise supreme authority within its jurisdiction. The Santiago Principles are an attempt to offer a compromise: they are designed to provide a framework that checks the freedom of governments to govern and operate their sovereign wealth funds, subject only to their own sovereign will. In doing so, the International Working Group expects the governments of recipient countries not to discriminate against the investment activities of sovereign wealth funds.
Non-economic motivations

They also address the issue of motivations other than economic or financial driving investment decisions. Principle 19 states: “The investment decisions should aim to maximise risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds.” Sub-principle 19.1 adds: “If investment decisions are subject to other than economic and financial considerations, these should be clearly set out in the investment policy and be publicly disclosed.” Noting this, the International Working Group explains that some sovereign wealth funds may exclude certain investments for various reasons, such as legally binding international sanctions or social, ethical, and religious reasons. The International Working Group adds that sovereign wealth funds may address social, environmental, or other factors in their investment policy, and that these reasons and factors should be publicly disclosed.

The wording of the Principle 19, the sub-principle and the explanation all suggest that investment decisions that are based on reasons other than financial and economic grounds are compliant with the other principles as long as a certain processes, including disclosure requirements, are observed. Focusing on procedural matters rather than substantial ones, this provision might prove unsatisfactory for those who argue that sovereign wealth funds’ investment policies should be based exclusively on economic and financial considerations.

New investor class

The principles are also an attempt to satisfy the demands from the public for more information about the newly-established investor class. And indeed the principles outline to need for disclosure of a number of elements: the key features of the sovereign wealth fund’s legal basis and structure, as well as the legal relationship between the sovereign wealth fund and other state bodies; its policy purpose; the policies, rules, procedures, and arrangements relative to the sovereign wealth fund’s general approach to funding, withdrawal, and spending operations; the governance framework and objectives, as well as the manner in which the sovereign wealth fund’s management is operationally independent from the owner; relevant financial information, such as asset allocation, benchmarks, or rates of return; and the investment policy.

These disclosure requirements contribute to the stability in international financial markets, and enhance trust in recipient economies. Notably, the principles do not ask for disclosure of the overall value of sovereign wealth funds, which may disappoint some observers. However, if implemented, the principles provide a solid foundation for meeting the most urgent demands for information about sovereign wealth funds.

Taking Santiago further

The Santiago Principles, therefore, provide a promising framework for the continuing integration of sovereign wealth funds into the global financial system. However, the relevance and impact of the principles will depend on the degree to which its constituents adhere to its standards. The principles do not have any legally binding force. They do not constitute international law to the extent of United Nations conventions, treaties and many other international agreements. Rather, the Santiago Principles are supported by the members of the International Working Group, which are sovereign wealth funds, and not the governments of nation states.
Against this one might argue that with the erosion of the power base of the sovereign nation state in recent years, the notion of international “soft law” has gained increasing relevance. The importance of soft law on the international stage has increased along with the increasing power and significance of non-state actors, such as trans-national corporations (TNCs), in international affairs. These corporations, for example, have felt the need to respond to growing environmental and social expectations of global society by developing various codes and agreements to outline accepted behaviour. Soft law, therefore, refers to quasi-legal instruments whose binding force is somewhat weaker than traditional international law and typically takes the form of voluntary codes of conducts, codes of practice, or guidelines. Such voluntary codes of conduct cut across national jurisdictions in an attempt to create a level playing field amongst its members – often to forestall heavy-handed regulation. Since voluntary codes of conduct are not legally binding, alternative and innovative means to enforce them have been employed. So-called “peer-review mechanisms” that rely on the collective motivation of members to adopt the substance of the codes of conduct, report on their implementation, and allow independent verification are generally held to be the most effective of these enforcement mechanisms.

General agreements on “principles” suggest a weaker form of such accords. Agreements on principles are intended to describe and formulate a set of fundamental assumptions – but they do not typically introduce a standard of behaviour that commits signatories to achieving it. The International Working Group has stated that the Santiago Principles are “a voluntary set of principles and practices that the members of the International Working Group support and either have implemented or aspire to implement.” This language is somewhat ambiguous: it remains unclear what it meant by introducing the terminology “voluntary set of principles”. It is neither a code of conduct nor generally verifiable truths or assumptions. This suggests that the International Working Group was somewhat uneasy to codify certain standards for sovereign wealth funds even on a voluntary basis, but wanted to give the impression that its members believe in the value of the substantial provisions documented in the Santiago Principles. Also, members merely “support” the principles – rather than adhere or commit to. This confirms the impression that the principles in effect attempt to strike a compromise between appeasing the demands for greater disclosure and committing its members to codified arrangements. This impression is confirmed by various passages of the document. The relevance of the Santiago Principles will, therefore, ultimately depend on the political will of individual sovereign wealth funds to accept them as general guidelines, and therefore implement them accordingly.

**The Kuwait meeting and beyond**

The most recent meeting of the International Working Group took place on 5 and 6 April this year in Kuwait City. Recognising that the thinking that underpinned the principles could benefit from a continuing exchange of views and study of activities, the International Working Group reached a consensus to establish the International Forum of Sovereign Wealth Funds, as part of the so-called Kuwait Declaration. The declaration notes that the forum will comprise a voluntary group of sovereign wealth funds. Its purpose is to encourage an exchange of views on
issues of common interest, and to facilitate the understanding of the Santiago Principles and sovereign wealth fund activities. It was important for the authors of the declaration to state that the forum will not be a supranational authority, and that its work shall not carry any legal force. The forum will operate in an inclusive manner and facilitate communication among sovereign wealth funds, recipient country officials, representatives of multilateral organisations and the private sector.

The Kuwait Declaration also suggests that the Santiago Principles continue to evolve due, but it remains unclear whether this likely to take the form of a decisive step in the direction of a more formal (and potentially more binding) code of conduct. The future direction the Santiago Principles will depend on the support they receive from the key players in the international debate on the role of sovereign wealth funds – that is, sovereign wealth funds themselves, and the governments of both the owner and recipient countries. Of critical importance is that the members of the International Working Group themselves see a clear benefit to committing to and implementing the principles. Those who have already implemented all or some of the principles need to see that others make progress as well.

**Self regulation**

Policymakers in recipient economies need to be convinced that the impetus for self-regulation amongst sovereign wealth funds is substantial enough to render a more heavy-handed policy response unnecessary. To be certain, the Santiago Principles have not formally taken into account the positions of recipient countries, though some of their representative bodies have been granted observer status in the ongoing process. To address this deficit, the Kuwait Declaration encourages cooperation with recipient countries, relevant international organisations and capital market functionaries to identify potential risks that may affect cross-border investments. It also called for the establishment of a committee (one of three others) to address the international investment environment and recipient country relationships. As a side note, it is interesting that sovereign wealth funds were not mentioned in the final declaration of the London Summit of the G20, which suggests some degree of confidence over the implementation of the Santiago Principles and the power of self-regulation.

In conclusion, it is clear that the public has developed a profound interest in the behaviour of sovereign wealth funds. Initially, when sovereign wealth funds appeared as active investors on the scene, many in recipient countries perceived them as a threat. In contrast, domestic constituents of sovereign wealth funds demanded more information and oversight when most sovereign wealth fund suffered sizeable losses in 2008. It appears obvious that, regardless of the future investment behaviour of sovereign wealth funds, an increasingly educated public audience – in both recipient and investing countries – will demand that it is correlated with a public purpose and disclosure.

**Notes**