

IS CalPERS A SOVEREIGN WEALTH FUND?

BY ASHBY H.B. MONK*

Introduction

Sovereign Wealth Funds (SWFs) are the subject of intense debate. While these funds are hard to define in precise terms, all agree they are government-sponsored pools of financial assets. With roughly \$3 trillion under management today and forecasts that suggest this number could approach \$10 trillion in under a decade,¹ many wonder what role these public investment funds will play in private markets.² Due to SWFs' government sponsorship, some fear that they will be used illegitimately to advance political, instead of commercial, agendas. This geopolitical concern is compounded by a general lack of transparency and a perception among Western analysts of weak accountability and poor governance practices.³

These fears are inspiring new rules designed to govern and regulate these institutions,⁴ and a series of new policy initiatives at the national and international level are in various stages of consideration and implementation (see Table 1 on the next page). For example, the U.S. Congress has held hearings and established a taskforce to determine if SWFs are a threat that requires new regulation. Australia and Germany have enacted new rules that address SWF investments. The International Working Group of Sovereign Wealth Funds, with the assistance of the IMF, has developed the voluntary 'generally accepted

principles and practices' for SWFs (also known as the Santiago Principles).

The prospect of new rules governing the conduct of SWFs raises the important question of which funds will be subject to such rules. Many financial institutions – especially public pension funds – are scrambling to differentiate themselves from SWFs in order to avoid increased regulation.⁵ Indeed, new policies mean new limitations on global investing, which would in turn limit a fund's ability to generate returns and diversify risk. As a result, how policymakers define SWFs is of the utmost importance.

To date, there has been some confusion as to what constitutes a SWF. While all seem to agree that the China Investment Corporation and the Abu Dhabi Investment Authority are SWFs, there is a lively debate as to whether public pension funds, such as the California Public Employees Retirement System (CalPERS), are also SWFs. While CalPERS itself is adamant that it is not, others disagree.⁶ The stakes are high for a fund like CalPERS, as the SWF label could come with a high cost.⁷

This *brief* seeks to establish consensus on a SWF definition. Building on this definition, it then evaluates whether a meaningful distinction can be made between public pension funds, such as CalPERS, and SWFs.

* Ashby H. B. Monk is a Research Fellow at the Center for Retirement Research at Boston College (CRR) and the University of Oxford. The author would like to thank Beth Almeida, Gordon L. Clark, Courtney Monk, Andrew Rozanov, Benn Steil, Edwin Truman, and Juan Yermo for comments on a previous draft.

TABLE I. EXAMPLES OF CURRENT SWF POLICIES

Country / Institution	Policy / Regulation
Australia	Published in February six principles to better vet investments by foreign government vehicles.
Canada	Reviewing its foreign-investment and ownership rules.
EU	Indicated that SWFs need to be more transparent and is reported to be considering new proposals.
France	Considering regulating SWFs and has called for a joint European response.
Germany	Approved a law to prevent foreign investors from taking large stakes in German companies.
IMF	Developed 24 Generally Accepted Practices and Principles (GAPP) for SWFs.
Italy	Indicated in October that SWFs' investments should 'generally' stay below 5 percent of local companies (according to Foreign Minister Franco Frattini).
OECD	Developing a series of voluntary best practices for SWF investment receiving countries.
United States	Created a Congressional taskforce in March to study how SWFs affect the economy and national security.

Source: Author's analysis.

Confusion Reigns

On a mid-summer visit to Russia, U.S. Treasury Secretary Henry Paulson told Prime Minister Vladimir Putin that he had had a productive discussion with Russian Finance Minister Alexei Kudrin about the country's SWF. Putin responded by saying, "Since we do not have a sovereign wealth fund yet, you are confusing us with someone else." To which Paulson replied, "We can discuss what you have called the various funds but we very much welcome your investment."⁸ This brief exchange is illustrative of the confusion surrounding SWFs: while Paulson was correct – Russia's National Wealth Fund is considered by many to be a SWF – Putin's response is also justifiable. A widely accepted definition of what exactly is a SWF has been elusive.

Andrew Rozanov, a Managing Director at State Street, first coined the term 'sovereign wealth fund' in 2005. He noted that SWFs were "neither traditional public pension funds nor reserve assets supporting currencies, but a different type of entity altogether."⁹ Rozanov was right; SWFs *are* different. However, three years on from his article, there is still no consensus as to how SWFs differ from other public investment funds and how they should be defined (see Box 1). In fact, Rozanov recently noted that SWFs "... differ in size, age, structure, funding sources, governance, policy objectives, risk/return profiles, investment horizons, eligible asset classes and instruments, not to mention levels of transparency and accessibility."¹⁰

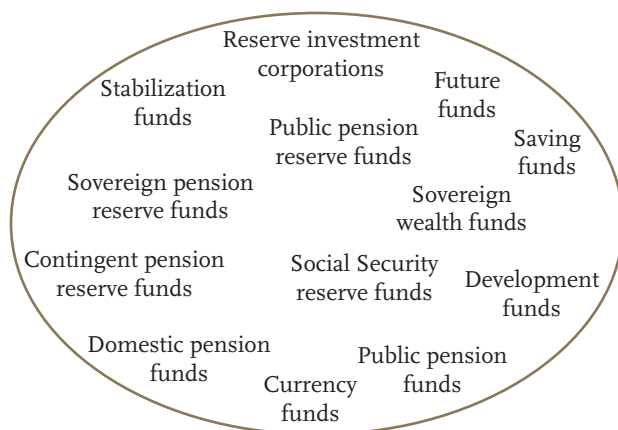
Box 1: Some SWF Definitions

- SWFs are investment vehicles funded by foreign exchange assets and managed separately from official reserves (U.S. Department of Treasury, 2007).
- SWFs are government-owned investment funds set up for a variety of macroeconomic purposes (International Monetary Fund, 2008).
- SWFs are special-purpose investment funds or arrangements that are owned by the general government (International Working Group of Sovereign Wealth Funds, 2008a).
- SWFs are "pools of assets owned and managed directly or indirectly by governments to achieve national objectives" (Organization for Economic Cooperation and Development: Blundell-Wignell et al., 2008).
- SWFs are "pools of money governments invest for profit" (Council on Foreign Relations: Teslik, 2008).

Indeed, the differences among purported SWFs are numerous. According to a recent survey conducted by the International Working Group of 20 SWFs, most were funded out of mineral royalties (primarily oil); however, some were funded from fiscal surpluses, foreign exchange reserves, borrowings from the market and even divestment proceeds.¹¹ Moreover, there was a straight 50-50 split among SWFs that were separate legal entities and those that were not. Finally, the funds themselves cited various objectives, including fiscal stabilization, general savings for future generations, and covering expected future pension expenditures. Undoubtedly, this degree of divergence in fundamental characteristics has been the source of much of the confusion.

Within the universe of existing financial institutions, it is possible to distinguish between those that are private (e.g. corporate pension funds) and those that are public (e.g. central banks). SWFs clearly fall into the public category. A further distinction can be made among public financial institutions: SWFs, which are public investment funds, are distinct entities from central banks.

FIGURE 1. PUBLIC INVESTMENT FUND SPHERE – CONFUSION REIGNS



Source: Author's illustration.

While these are important distinctions to note, further categorization within the public investment fund sphere remains difficult; this is where the confusion reigns. A review of recent academic and policy papers unearths countless labels for different types of public funds (see Figure 1). Mastering the lexicon is clearly arduous, but the difficulties do not stop here. While some seek to highlight the differences and separate the various types of funds, others would like to include them all in a general SWF category. In short, narrowing down the focus to public investment

funds actually complicates the task because opinions differ as to whether and how further categorization can be done.¹²

A SWF Definition

There is a fine line between making a SWF definition too general (including all public investment funds) and too specific (eliminating some funds that deserve the SWF label). For example, limiting the SWF definition (as the U.S. Treasury does) to those funds that receive their capital from foreign exchange reserves would eliminate well-established SWFs, such as Singapore's Temasek.¹³ A critical and careful review of the existing literature and research is extremely useful in walking this line. Indeed, emerging from this body of work are the foundations of a workable definition. Three characteristics emerge as crucial components of any SWF definition:

1) Ownership: Governments, both central and sub-national, own and, to varying degrees, control SWFs. Control can be exerted either directly or indirectly through the appointment of the SWF board.

2) Liabilities: One point of agreement illustrated by the International Working Group's recent survey of SWFs was that they "have no direct liabilities."¹⁴ This is perhaps a surprising point of agreement, as certain SWFs do have liabilities, such as sterilization debt or some deferred contractual liability to transfer money out of the SWF and into the general budget or a social security system.¹⁵ However, the point being made is that SWFs have no outside (non-governmental) liabilities. For those SWFs that have a liability, it is typically intra-governmental; one arm of the government owes another arm of the government money. For example, the SWF might owe the ministry of finance, the central bank or even the social security reserve fund money. However, SWFs have no external creditor, which means the assets are not encumbered by the property rights of outside, non-governmental owners. In short, SWF liabilities (if they have any) are part of the broader national balance sheet.

3) Beneficiary: Despite certain explicit goals (e.g. filling a future PAYG pension gap), SWFs are managed according to the interests and objectives of the *government*. As the accounting distinction underpinning point 2 above suggests, the ultimate beneficiary of a SWF is not a specific individual. Rather, since the government itself determines the SWF's objec-

tive function, the beneficiary is either the government itself, the country's citizenry in abstract, the taxpayer generally or is simply left unidentified. This objective function alters the strategic choices made by the funds' managers.

These three characteristics suggest the following technical definition: *SWFs are government-owned and controlled (directly or indirectly) investment funds that have no outside liabilities or beneficiaries (beyond the government or the citizenry in abstract) and that invest their assets, either in the short or long term, according to the interests and objectives of the sponsoring government.*

This definition is suitable for three reasons. First, it underscores the vulnerability of SWFs to political influence. Because the assets are owned by the government and invested in accordance with its interests, the concerns surrounding these institutions are perhaps easier to understand – whether these concerns are justified is beyond the scope of this *brief*.

Second, the above definition makes no mention of accountability, transparency, or governance. While some funds, such as the Canada Pension Plan Investment Board, have tried to differentiate themselves from SWFs on the grounds that they have higher than average levels of transparency, accountability, and governance,¹⁶ such distinctions seem to suggest that the term 'sovereign wealth fund' is tantamount to unaccountable, nontransparent, or poorly governed.¹⁷ This is an error. As SWFs become more transparent, accountable, or better governed, will they 'graduate' from being a SWF?¹⁸ Consider a different type of financial institution: are central banks with perfect governance practices and those with deficient governance practices all still central banks? The obvious answer is yes; the same principle should hold for SWFs.

Finally, given the heterogeneous nature of the SWF population, the definition does not use specific sources of capital (such as commodities or foreign exchange reserves) or legal status as a defining characteristic. The International Working Group's survey illustrates that generalities in this regard are necessary. Nevertheless, as the liabilities section above implies, sources still do have a role in this definition. Indeed, whether the money comes from within or without the government has implications for the categorization.

Are Public Pensions SWFs?

SWFs have intra-governmental liabilities and beneficiaries, differentiating them from other public investment funds, such as public pension funds. Accordingly, the IMF eliminates pension funds from its

SWF definition, noting that pensions, unlike SWFs, have specific individual beneficiaries.¹⁹ Indeed, pension funds are beneficial institutions in that their participants have specific claims on the assets in the fund. As noted above, SWFs do not have this type of claim on their assets; claims on SWF assets reside within the government itself.

Following on from the liability, fiduciary duty is also an important way to separate public pension funds from SWFs. In the United States, fiduciary duty requires that all decisions be made with the beneficiaries' retirement security in mind; thus no pension can place any other constituent above its beneficiaries. In theory, this ensures that pensions remain focused exclusively on the maximization of financial returns, as opposed to political goals. While in practice public pension funds have occasionally fallen short of this standard,²⁰ fiduciary duty remains a defining characteristic of a public pension fund. SWFs do not have this kind of first principle to guide their investment strategy (see Table 2).

TABLE 2. SWFs, PUBLIC PENSION FUNDS (PPF), AND CORPORATE DB PENSIONS (CDBP)

	SWF	PPF	CDBP
Sponsor	Government	Government	Firm
Control	Government	Independent board	Independent board
Beneficiary	Government	Workers/retirees	Workers/retirees
Liability	Government/none	Pensioner	Pensioner
Fiduciary duty	No	Yes	Yes
Example	China Investment Corporation	CalPERS	General Motors

Source: Author's illustration.

In order to crystallize the distinction, consider two similar public investment funds: pension reserve funds, which have a general objective to support PAYG social security systems,²¹ and public pension funds. Juan Yermo of the OECD suggests that reserve funds are SWFs because they have no explicit liabilities (outside the boundaries of the government) and are managed according to the interest of the sponsoring government, i.e. alleviating future budget constraints stemming from the expected high cost of PAYG pensions.²² In contrast, public pension funds have explicit liabilities and an obligation (and fiduciary duty) to pay public sector pensions. Therefore, they should not be considered SWFs.

Why CalPERS is *Not* a SWF

All public financial institutions are to some extent vulnerable to political influence.²³ CalPERS is no exception, as it has been subject to politicized investment strategies (coming from the Legislature) in the past. For example, California has enacted legislation requiring certain investment policies, such as the divestments of public companies that do business in Sudan, Iran and South Africa during apartheid.²⁴ However, even in these instances, fiduciary duty remained the ultimate test of the policies' feasibility. The divestment bills were all subject to review by the CalPERS board to ensure that divestment was consistent with the responsibility to maximize financial returns for the exclusive gain of the beneficiary.²⁵ As a result, these policies were justified on the grounds that they would actually improve risk-adjusted returns, since firms engaging in commercial operations in Iran or Sudan were seen to be vulnerable to hard-to-quantify geopolitical risks – whether or not this justification is correct is beyond the scope of this *brief*.

In any case, using these instances as justification for labeling CalPERS a SWF fails to recognize fully the nature of this financial institution (and the nature of a SWF). CalPERS is not state-owned or controlled. California State government makes employer contributions to the Fund, which are roughly matched by equivalent contributions by public employees who are members of CalPERS. The independent board of directors, which is subject to fiduciary duty, then administers the money on behalf of the *plan beneficiaries*. Indeed, as mandated by the California State Constitution, CalPERS Board of Administration has the sole authority to make investment decisions on behalf of the pension fund's 1.5 million active and retired public employees. CalPERS is constitutionally mandated to maximize returns, which should (in theory) provide immunization against any political interference. Consequently, CalPERS is not a SWF (see Box 2).

Conclusion

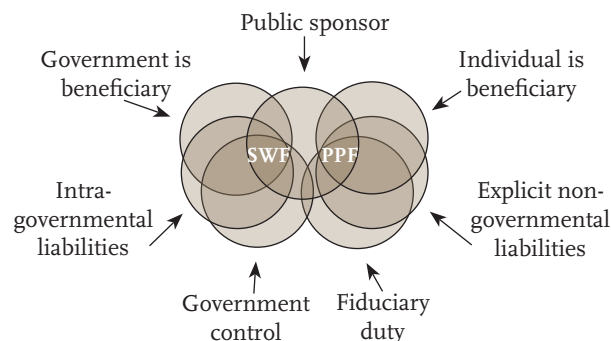
SWFs are government owned and (to varying degrees) controlled, they lack specific liabilities and beneficiaries outside of the government or the citizenry in abstract, and they are managed for the general welfare of the sovereign sponsor. Held to this standard, CalPERS is not a SWF. Despite past investment policies

Box 2: Why CalPERS is *Not* a SWF

- It is not directly controlled or owned by the state.
- It does not manage state-owned assets.
- All investment policies – even those mandated through the Legislature – must not impinge on fiduciary duty to maximize returns for the exclusive gain of beneficiaries.
- Fund beneficiaries are public workers and retirees, not the state of California.

that were seemingly based on political criteria, its strict mandate and fiduciary duty forces it to justify all investment policies on the basis of financial returns. As such, CalPERS, and other public pension funds, should not be included in any SWF definition (see Figure 2). More importantly, they should not be subject to any new protectionist policies designed to thwart SWF threats, real or perceived. This conclusion is significant, as the alternative might have constrained CalPERS' ability to generate returns and, ultimately, pay promised pensions.

FIGURE 2. DIFFERENTIATING BETWEEN SWFs AND PUBLIC PENSION FUNDS (PPF)



Source: Author's illustration.

Endnotes

- 1 Jen and Andreopoulos (2008).
- 2 U.S. Senator Charles Schumer (2008) recently testified: “The question of the day is whether these huge pools of investment dollars, known as sovereign wealth funds, make the U.S. economy stronger or pose serious national security risks.”
- 3 Clark and Urwin (2008) and Truman (2008).
- 4 See Senator Evan Bayh’s (2008) op-ed in *The Wall Street Journal*.
- 5 For example, the Canada Pension Plan Investment Board has taken great pains to differentiate itself from SWFs (see Bisch, 2008).
- 6 For example, Benn Steil (2008) of the Council on Foreign Relations recently argued, “California runs the second largest SWF in the world...”, and Edwin Truman (2008) of the Peterson Institute has also included CalPERS in his SWF definition.
- 7 Ironically, California’s legislature recently provided evidence of the potential backlash against SWFs. Assembly Bill 1967, which was later withdrawn, would have prevented CalPERS from investing with private equity companies with any ownership by sovereign wealth funds coming from countries with a poor human rights record.
- 8 Reuters (2008).
- 9 Rozanov (2005).
- 10 Rozanov (2008).
- 11 International Working Group of Sovereign Wealth Funds (2008b).
- 12 For example, Mitchell, Piggott, and Kumru (2008) view stabilization funds and SWFs as distinct entities, while the IMF lumps stabilization funds into its SWF definition.
- 13 Nugée (2008).
- 14 International Working Group of Sovereign Wealth Funds (2008b).
- 15 Rozanov (2008).
- 16 Bisch (2008).
- 17 Instead, the Canada Pension Plan is not a SWF because the government has no claims to the assets in the plan, the assets are contributed by employees and employers, it receives no general tax revenues, and, by law, it is not managed according to the interests of the sponsor but to maximize investment returns for beneficiaries
- 18 SWFs are set up in response to the accumulation of wealth, while public pension funds are set up for the purpose of wealth accumulation. This differentiation has led Ambachtsheer (2008) to refer to SWFs as “accidental financial tourists.” While it is true that some SWFs were thrust onto the global stage before they had a chance to set up the appropriate governance mechanisms, this is not how SWFs and public pension funds should be categorized – it simply helps to explain current practice within the two categories.
- 19 International Monetary Fund (2008).
- 20 Romano (1993).
- 21 Examples of such funds include Ireland’s National Pensions Reserve Fund and New Zealand’s Superannuation Fund.
- 22 Yermo (2008).
- 23 As Romano (1993) argued, “Public fund managers must navigate carefully around the shoals of considerable political pressure to temper investment policies with local considerations, such as fostering in-state employment, which are not aimed at maximizing the value of their portfolios’ assets” (see also Hess, 2005). It is this vulnerability to political influence that has led many to label CalPERS a SWF. As Benn Steil argued in his *Wall Street Journal* article, “CalPERS is a political entity in every sense of the word” (Steil 2008).
- 24 Munnell (2007).
- 25 Indeed, the recent Iran divestment bill (AB 221) included the following sentence: “The California Constitution provides that the Legislature may by statute prohibit retirement board investments if it is in the public interest to do so, and providing that the prohibition satisfies specified fiduciary standards.” Also, see Testimony by Chief Investment Officer Russell Read on AB 1967 (Torrico) – Assembly Public Employees, Retirement Social Security Committee, April 9, 2008. He notes that past Bills include a clause that reads, “subject to review by the CalPERS board that the actions are consistent with the board’s fiduciary responsibilities.”

References

- Ambachtsheer, Keith. 2008. "Sovereign Wealth Funds: Friends or Foes?" *The Ambachtsheer Letter* 264.
- Bayh, Evan. 2008. "Time for Sovereign Wealth Rules." *Wall Street Journal*. February 13.
- Bisch, Don. 2008. "Identity Crisis." *Benefits Canada* 32(2): 70-71.
- Blundell-Wignall, Adrian, Yu-Wei Hu, and Juan Yermo. 2008. "Sovereign Wealth and Pension Fund Issues." Working Papers on Insurance and Private Pensions, No. 14. Paris, France: Organisation for Economic Cooperation and Development.
- Clark, Gordon L. and Roger Urwin. 2008. "Best-Practice Pension Fund Governance." *Journal of Asset Management* 9: 2-21.
- Hess, David. 2005. "Protecting and Politicizing Public Pension Fund Assets: Empirical Evidence on the Effects of Governance Structures and Practice." *U.C. Davis Law Review* 39(1): 187-224.
- International Monetary Fund (IMF). 2008. "Sovereign Wealth Funds – A Work Agenda." February 29. Washington, DC.
- International Working Group of Sovereign Wealth Funds (IWG). 2008a. "Sovereign Wealth Funds Generally Accepted Principles and Practices: Santiago Principles." October.
- International Working Group of Sovereign Wealth Funds (IWG). 2008b. "Sovereign Wealth Funds: Current Institutional and Operational Practices." Report Prepared by the IWG Secretariat in Collaboration with the Members of the IWG. September 15.
- Jen, Stephen and Spyros Andreopoulos. 2008. "SWFs: Growth Tempered – US\$10 Trillion by 1015." *Global Economic Forum*. November 10. Available at: <http://www.morganstanley.com/views/gef/archive/2008/20081110-Mon.html#anchor7146>.
- Mitchell, Olivia, John Piggott, and Cagri Kumru. 2008. "Managing Public Investment Funds: Best Practices and New Challenges." Working Paper 14078. Cambridge, MA: National Bureau of Economic Research.
- Munnell, Alicia H. 2007. "Should Public Plans Engage in Social Investing?" *Issue in Brief* 7-12. Chestnut Hill, MA: Center for Retirement Research at Boston College.
- Nugée, John. 2008. "The Growing Role of Sovereign Wealth Funds." *State Street Vision* III(2): 3-12.
- Reuters. 2008. "Putin-No Sovereign Wealth Fund in Russia Yet." June 30. Available at: <http://www.reuters.com/article/marketsNews/idUSL3028241920080630>.
- Romano, Roberta. 1993. "Public Pension Fund Activism in Corporate Governance Reconsidered." *Columbia Law Review* 93(4): 795-853.
- Rozanov, Andrew. 2005. "Who Holds the Wealth of Nations?" *Central Banking Journal* 15 (November): 52-57.
- Rozanov, Andrew. 2008. "A Liability-Based Approach to Sovereign Wealth." *State Street Vision* III(2): 15-20.
- Schumer, Charles E. 2008. "Opening Statement, Do Sovereign Wealth Funds Make the US Economy Stronger or Pose National Security Risks?" Joint Economic Committee Hearing, U.S. Congress, February 13. Washington, DC.
- Steil, Benn. 2008. "California's Sovereign Wealth Fund." *Wall Street Journal*. March 7.
- Teslik, Lee H. 2008. "Sovereign Wealth Funds." Council on Foreign Relations Backgrounder. Washington, DC: Council on Foreign Relations.
- Truman, Edwin M. 2008. "A Blueprint for Sovereign Wealth Fund Best Practices." *Policy Brief* PBo8-13. Washington, DC: Peter G. Peterson Institute for International Economics.
- U.S. Department of Treasury. 2007. "Appendix III, Report to Congress on International Economic and Exchange Rate Policies." Washington, DC.
- Yermo, Juan. 2008. "Governance and Investment of Public Pension Reserve Funds in Selected OECD Countries." Working Paper on Insurance and Private Pensions 15. Paris, France: Organisation for Economic Co-Operation and Development.

CENTER FOR
RETIREMENT
RESEARCH
AT BOSTON COLLEGE

About the Center

The Center for Retirement Research at Boston College was established in 1998 through a grant from the Social Security Administration. The Center's mission is to produce first-class research and forge a strong link between the academic community and decision makers in the public and private sectors around an issue of critical importance to the nation's future. To achieve this mission, the Center sponsors a wide variety of research projects, transmits new findings to a broad audience, trains new scholars, and broadens access to valuable data sources. Since its inception, the Center has established a reputation as an authoritative source of information on all major aspects of the retirement income debate.

Affiliated Institutions

The Brookings Institution
Massachusetts Institute of Technology
Syracuse University
Urban Institute

Contact Information

Center for Retirement Research
Boston College
Hovey House
140 Commonwealth Avenue
Chestnut Hill, MA 02467-3808
Phone: (617) 552-1762
Fax: (617) 552-0191
E-mail: crr@bc.edu
Website: <http://www.bc.edu/crr>

The Center for Retirement Research thanks AARP, AIM Investments, Bank of America, Deloitte Consulting LLP, ING, John Hancock, MetLife, Nationwide Mutual Insurance Company, Prudential Financial, State Street, TIAA-CREF Institute, and T. Rowe Price for support of this project.

© 2008, by Trustees of Boston College, Center for Retirement Research. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that the author is identified and full credit, including copyright notice, is given to Trustees of Boston College, Center for Retirement Research.

The research reported herein was supported by the Center's Partnership Program. The findings and conclusions expressed are solely those of the author and do not represent the opinions or policy of the partners or the Center for Retirement Research at Boston College.