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Sovereign Wealth Funds, Debt Issuances, and the Development of Capital Markets

Patrick J. Schena
Ravi Shankar Chaturvedi[1]

Can and do sovereign wealth funds (SWF) promote the development of capital markets? SWFs are frequently maligned for pursuing objectives that extend beyond specific financial or investment mandates and performance goals to include extra-fund objectives. Certainly the keen interest and focus of most observers of such matters is on the political or geo-strategic nature of such agendas. However, can SWFs pursue auxiliary goals with positive externalities globally? In this context, we consider the role of SWFs in the development of local or regional capital markets.

To constrain the ambition of our immediate scope, we seek in this note to introduce and briefly reflect on the recent bond issuances by Temasek and Khazanah. These were respectively a Singapore dollar, exchangeable note and a Shariah-compliant renminbi (RMB) note. Each was creative in structure and opportunistic with respect to current market conditions.

The conventional analytical view of sovereign wealth funds (SWF) is asset-based. That is when understanding the mandate and objectives of individual institutions we frequently focus on such dimensions of the fund as asset allocation and mix, investment policy and selection, and performance. Less frequently do we study the liability structure of funds with the same level of interest and intensity.

As with any economic entity the nature of SWF liabilities varies as widely as the nature of individual institutions. Here for convenience[2] we might differentiate between two broad classes of funds: wealth

[1] Patrick Schena is Adjunct Assistant Professor of International Business and Senior Fellow, Center for Emerging Market Enterprises, The Fletcher School, Tufts University; Ravi Shankar Chaturvedi is a candidate for Master's in International Business, The Fletcher School
[2] Certainly the taxonomic breath of categorizing SWFs is considerably broader.

funds and development funds. The objective of the former is to manage and grow portfolios for real and financial assets for the benefit of the stakeholders, while the mandate of the latter may additionally include the management and disposition of physical assets, including privatization.

In the case of wealth funds and specifically those that have more the characteristics of a pension scheme, liabilities in the form of annual annuities may be well defined. For funds that seek to smooth intergeneration flows and manage fiscal demands, specific liabilities may be discrete, but not well articulated. For wealth funds that have a stabilization mandate, liabilities may be decidedly more contingent, i.e. based upon unforeseen circumstances and events. Finally, the notion of "social arrears" or liabilities has also been introduced into the academic debate.[3]

Funds with a development or transformational mandate often have a different operating model, which requires sizeable amounts of both short and long-term operating capital to support their investment programs and the liquidity or capital needs of portfolio companies. In this respect, development funds, especially those in emerging markets, may enjoy greater debt access and capacity than selected investee firms and so function as a networked entity with an embedded internal capital market, under which the fund borrows and on-lends. Liabilities in this context will include both loans and bonds with the latter issued in both global and regional markets.

Borrowing by sovereign wealth funds is certainly not novel, nor is issuing debt securities. In addition to those we will discuss below, examples include issuances by Abu Dhabi's Invest AD and Bahrain's Mumtalakat, whose inaugural issue was floated in 2010[4]. Temasek has been issuing bonds in US and Singapore Dollars and British Pounds since at least 2005. Temasek's current debt structure includes eleven issuances totaling over S$ 8 billion with tenors ranging from 10 to 40 years.[5]

The China Investment Corporation (CIC) was originally capitalized via Ministry of Finance issuance of RMB 1.55 Trillion (USD 200 Billion). The CIC was responsible for servicing this issuance at a daily cost of USD 40 Million.[6] This liability, while indirect, in effect defined a baseline level of return for the CIC. More directly, Central Huijin Investment Co., an investment unit of the CIC, through which the central government controls major state-owned Chinese financial institutions, announced domestic market

[3] See Patrick J. Keenan, "Sovereign Wealth Funds and Social Arrears: Should Debs to Citizens Be Treated Differently than Debts to Other Creditors?", Virginia Journal of International Law, Vol 49:2 2009

[4] "CIC arm to raise $28 billion through bond issuance: reports", accessed November 11, 2011 at http://www.centralbanking.com/central-banking/news/1727798/cic-arm-raise-usd28-billion-bond-issuance-reports

[5] Temasek Review 2011, p 31

[6] Michael F. Martin, "CRS Report for Congress: China's Sovereign Wealth Fund", Congressional Research Service, January 22, 2008, p 6

issuances in 2010. The proceeds of these issuances were described variously as to maintain and support Central Huijin's investments in commercial lenders and export-oriented financial institutions.[7]

This prior issuing experience notwithstanding, we are drawn to two quite recent issuances by respectively Temsasek and Khazanah, primarily for their creativity. In mid October Temasek announced a unique addition to its debt structure: the issuance of a *zero yield* exchangeable bond that was targeted to raise S$ 800 Million. The bond carries a three-year maturity and is exchangeable into shares of Standard Chartered Bank, a portfolio holding of Temasek, at a premium of 27% over GBP 14.29.[8] The interesting dimension of the bond is Temasek's ability to systemically reduce its holding in an investee company at a premium over the current market price while enjoying nominally *interest-free financing* for three years.

While creative, the exchangeable feature is not necessarily innovative, as Temasek has in the past issued exchangeable notes to divest portions of its investments.[9] It is important to note that Temasek will not entirely divest of its holding of Standard Chartered via the issuance. In fact, full conversion will result in Temasek trimming its 18% position by a mere 1%. Temasek is rated AAA by both Moody's and S&P. Rather, the value in the debt issuance to Temasek is its leverage in the Standard Chartered equity position that affords the Singapore investment fund the ability to issue zero cost debt in an already low interest rate environment.

Also in October Khazanah Nasional, the investment holding company of the Government of Malaysia issued the first RMB denominated Sukuk. The three-year note raised RMB 500 Million. The bond was targeted at both conventional and Islamic investors interested in a RMB exposure and was well received. Especially interesting is Khazanah's positioning of the transaction in the broader context of Malaysia's agenda toward Islamic finance: "The Sukuk demonstrates Khazanah's continued commitment towards the expansion of Islamic finance in line with the Government of Malaysia's agenda to establish Malaysia as an Islamic finance hub. It also attests to Khazanah's continued effort to push the envelope on transaction innovation and the competitive positioning for Islamic structures."[10]

Like Temasek, Khazanah has a history of successful bond issuances, with USD 8.1 Billion of bonds and loans maturing before 2014.[11] Though innovative in its choice of issuing currency, the note is not the first Islamic issuance by Khazanah, but follows Sukuk offerings in Singapore in August 2010. These

[7] "Central Huijin planning bond sales", China Daily, August 5, 2010, accessed Novermber 12, 2011 at http://www.chinadaily.com.cn/business/2010-08/05/content_11099564.htm
[8] "Temasek raises S$800m in bind issue", Financial Times, October 18, 2011
[9] "Presale: Temasek Holdings Pte Ltd", Ratings Direct, Standard & Poor's, September 12, 2005
[10] See Khazanah Nasional website, accessed November 11, 2011 at http://www.khazanah.com.my/docs/KNB_Sukuk_131011.pdf
[11] "Khazanah Said to revive Its Offering of World's First Yuan Islanic Binds", Bloomberg, October 13, 2011

represented the largest and longest Sukuk issuances in Singapore at the time and, like the RMB offering, were issued via a Malaysian-incorporated special purpose vehicle, Danga Capital Berhad.[12]

Despite their clear differences both issuances form part of a wider framework by both organizations to expand access to long-term, capital market debt at attractive costs. As issuers, both Temasek and Khazanah conform to disclosure and issuing requirements including the distribution of appropriate offerings circulars. In fact, such offering documents are detailed and often more extensive than annual reports or reviews otherwise made available by either.[13] Thus, the process of raising capital market debt has expanded the stakeholder base of these funds and increased their disclosure and transparency, while exposing them to the scrutiny and discipline of global debt markets. Perhaps of equal import, such issuances, in the broader issuing context of both funds, have arguably expanded the liquidity and maturity structures of the markets in which they are issued and so have advanced the deepening of these regional debt markets.

[12] See Khazanah Nasional website, accessed November 11, 2011 at http://www.khazanah.com.my/docs/Media%20Statement_Khazanah_030810.pdf

[1313] The offering circular for Mumtalakat's USD 750 Million notes issued in 2010 is equally detailed and supplementary with respect to other information released by the fund. See Bahrain Mumtalakat Holding Company B.S.C.(c) U.S.$750,000,000 5% Notes due 2015 Prospectus