

The background of the page is a solid orange color. Overlaid on this background is a network diagram. It consists of several nodes, represented by small dark red circles, connected by thin dark red lines. The nodes are arranged in a roughly circular pattern, with some larger, semi-transparent circles of varying shades of orange and red acting as hubs or background elements. The lines connect the nodes in a way that suggests a complex, interconnected network.

Patrick J. Schena

PhD, Adjunct Assistant Professor & Senior Fellow and Co-Head SovereigNET: The Fletcher Network for Sovereign Wealth and Global Capital
The Fletcher School, Tufts University

Looking Back and Launching Forward: SWF Investment in Financial Services

9. Looking Back and Launching Forward: SWF Investment in Financial Services

Introduction

It is inevitable that we begin a review of the 2013 investment trends of SWFs in banking and financial services with one eye on the past. While seemingly far distant, the throes of the financial crisis of 2008-09 in some ways reoriented our thinking about the role of SWFs as strategic global investors. In the few years prior to the crisis, the world had become captivated by these amassing pools of state-controlled wealth, but with growing concern for their impacts on capital markets and global financial stability¹. As the economies gasped for liquidity, deep pools of long horizon capital were sought out to arrest the fleeting capital base of large global financial institutions.

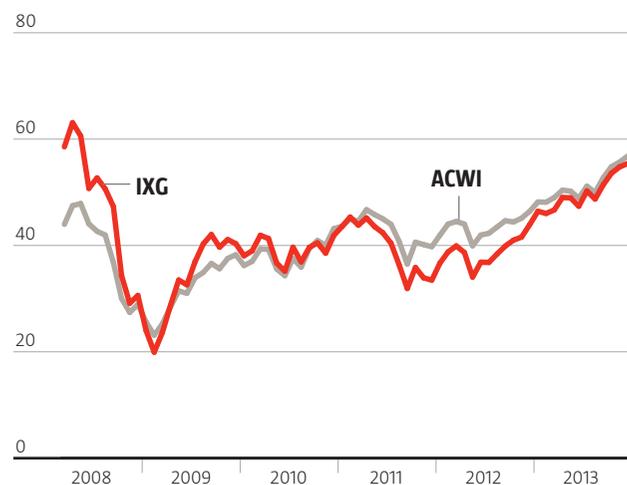
Whether cross border—as in the case of GIC or Temasek—or to stabilize a domestic banking sector—as in the case of Ireland—SWFs nimbly anchored over \$70 billion in recapitalizations and emerged as among the largest investors in global financial services. With nearly 270 deals in the sector since 2006, over 70% of these were completed after the onset of the global financial crises (from now on referred as GFC) in many cases representing follow-on commitments. Rather than destabilize, these transactions represent a base of long-term capital that has contributed to the stability of the global financial system and some respects forced a reconsideration of the SWF from that of “powerbroker”² to sophisticated strategic financier. As the memory of the Global and Euro crises begins to fade the legacy of these investments continues to define the portfolios of SWFs. This poses an important question about the future role of SWFs as investors in the sector: What defines the current strategic objectives of SWFs in global financial services and what are the resulting implications?

Financial services without question remains the largest sector into which SWFs invest, representing over 30% of all transactions since 2006. In the years preceding the GFC, SWF investment in financial services increased steadily, peaked in 2010 at 50 transactions, dropped precipitously by over 40% in 2011, and has been recovering since. SWF investment activity in 2013 in particular marked resurgence in financial services, driven largely by investments in banks and various forms of fund or privately intermediated structures. Of the 45 deals completed in financial services in 2013, 13 were investments in commercial and investment banks, 6 in insurance firms, and 2 in exchanges. In addition, 20 investments were made in intermediary vehicles or fund structures, heavily dominated by real estate, infrastructure, and private equity funds.

A key driver of investment in this sector, we suggest, has been a recovery of returns to global financial services generally. As a proxy for SWF returns in the sector we take as a benchmark an ETF indexed to the S&P Global Financials Sector. When measured since the second quarter of 2008, i.e. in the midst of the GFC, the sector has significantly underperformed the MSCI All Country World Index on a cumulative basis. This is clearly discernible in Chart 1 as both indices drop to lows in the first quarter of 2009. The global financial services index has yet to return to 2008 levels on an adjusted basis, suggesting that holding period returns on some SWF global financial positions remain flat. However, the recovery in global equities since the GFC, and with it the financial sector, has offered opportunities to enhance performance. Importantly, informing the sector investment focus by SWFs since 2012, the global financial services index returned over 31% in 2012 compared to a 16.7% return in the same period for the MSCI all countries index. In 2013, returns were respectively 26% versus 22%, i.e. continued though more modest outperformance.

Chart 1

Relative Price Movement of the S&P Global Financials (IXG) against the MSCI All Country World Index (ACWI)



Source: Yahoo Finance (2014) and author's calculations.

Traditionally, the most active SWFs in the financial sector are among the largest each with considerable scale and commitment to a long-term investing horizon. These have included ADIC, CIC, GIC, KIA, QIA, and Temasek, who together have been responsible for almost 60%

¹ See for example McKinsey 2014, “The new power brokers: How oil, Asia, hedge funds, and private equity are shaping global capital markets ...” accessible via http://www.mckinsey.com/insights/global_capital_markets/how_the_new_power_brokers_are_shaping_global_capital_markets
² Ibid.

of SWF transactions in financial services since 2006. As a result they hold sizeable legacy positions in global banking institutions. In 2013 Malaysia's Khazanah, an active investor in the insurance sector, joined this cohort, which as a whole combined for 78% of the financial sector deals by SWFs.

The legacy of SWF in financial services has perhaps been most pronounced and effectual in the banking sector specifically. In global markets their list of active engagement is long: Citigroup by among others Kuwait and ADIA; Morgan Stanley by CIC among others; European banking sector, including UBS by GIC; Barclays by International Petroleum Investment and Qatar; Credit Suisse and Greek banks, EFG Eurobank and Alpha Bank, by Qatar; in Unicredit by IIA. And, of course, the Chinese state banking sector by any number of funds including GIC and Temasek.

In domestic markets, SWF investments in financial services, and banking in particular, have reflected the complex realities of the strategic links between the financial and real economies. In some cases, China for example, the role of the SWF in domestic banking has been institutionalized through the establishment of a discrete subsidiary or holding company whose mandate is to administer the state's investment in the domestic banking sector. In other cases, the assets of an existing sovereign entity without such a mandate have been actively deployed to recapitalize elements of the domestic banking sector in some cases with significant structural implications for the fund itself. In 2013 we were able to examine this dichotomy as it unfolds in a present day tale of two cities: Beijing and Dublin.

Beijing and Dublin: A tale of two cities

In Beijing, the China Investment Corporation (CIC) directs investment in China's banking sector through Central Huijin Investment, whose responsibility it is to manage the Chinese government's ownership in the national banking sector. Huijin was established in 2003 and, along with its holdings of Chinese bank shares, was later acquired by CIC. Its current positions include the Chinese state government's ownership interests in Agricultural Bank of China, Bank of China, China Construction Bank, and Industrial and Commercial Bank of China among other banks and non-bank financial institutions. Huijin's positions in these four banks constituted on average 50% of their share capital (ranging from approximately 35% in the case of ICBC to over 67% for the Bank of China). The total book value of its holdings as of December 2013 was approximately \$136 billion³.

In Dublin, the Irish government also holds substantial ownership interests in two key national banking institutions: Allied Irish Banks

and the Bank of Ireland. Share ownership is through what was originally the National Pensions Reserve Fund of Ireland from the assets of which the banks were — somewhat by fiat — re-capitalized. Here however, the similarities end.

Huijin's management style might be described as decidedly macro-policy driven and proactive. Huijin has been an active acquirer of shares in Chinese state banks through what have amounted to open market operations that are design not only to provide price support to Chinese bank shares, but also — through a form of forward guidance — to signal government support for Chinese equity values more generally. Beginning in 2011 and continuing through four consecutive quarters into the fall of 2012, Huijin added to its sizeable positions in Chinese banks⁴.

In June, 2013, Huijin resumed this share purchase program and again formally announced its intention to increase its equity stake in all four Chinese state-owned banks over the succeeding six months. The operation, executed through purchases of free float shares on the Shanghai stock exchange, left the banks' registered capital levels unaffected⁵. Once completed in mid-December, Huijin had increased its stakes in ICBC by 175 million A-shares or to a share ownership position of about 35.36 percent. Likewise, Huijin acquired 103 million A-shares of CCB resulting in ownership of 57.26 percent. Huijin also bought 113 million of its A-shares of Bank of China to increase its stake to 67.75 percent. Lastly, it acquired 179 million A-shares of Agricultural Bank of China resulting in an ownership position of 40.28 percent⁶. In a similar program executed simultaneously, Huijin also acquired additional shares in China Everbright Bank and New China Life Insurance Co⁷.

During the three years period ending December 31, 2013, depicted in the chart 2, the Shanghai index *declined* cumulatively nearly 25%, while the shares of these Chinese four state-owned banks (SOBs) remained relatively flat, returning -0.5%. Nonetheless, the impact of Huijin's share purchase programs can be casually discernible when tracing the relative price movements of the Shanghai index and those of China's four largest state-owned banks. During the period of the 2013 Huijin share purchase operation from June through mid-December, the Shanghai index increased in value by approximately 7%.

³ To put this number into context, at December 31, 2013 the CIC, in its annual financial statements, reported total assets of \$653B and specifically the value of its "financial assets at fair value" as \$205B and the value of its "long-term equity investments" as \$412B. See <http://www.china-inv.cn/wps/wcm/connect/5c337c13-8677-4862-aa36-4efbc1b243ae/中投年报电子书文件—英文.pdf?MOD=AJPERES&CACHEID=5c337c13-8677-4862-aa36-4efbc1b243ae>

⁴ "Central Huijin continues purchase of bank shares," China Daily, 10 October 2012.

⁵ "China sovereign fund Huijin completes purchase of bank shares", Reuters, 16 December 2013.

⁶ "Central Huijin raises stake in four state banks", Xinhua, 17 December 2013 at http://news.xinhuanet.com/english/china/2013-12/17/c_132974582.htm

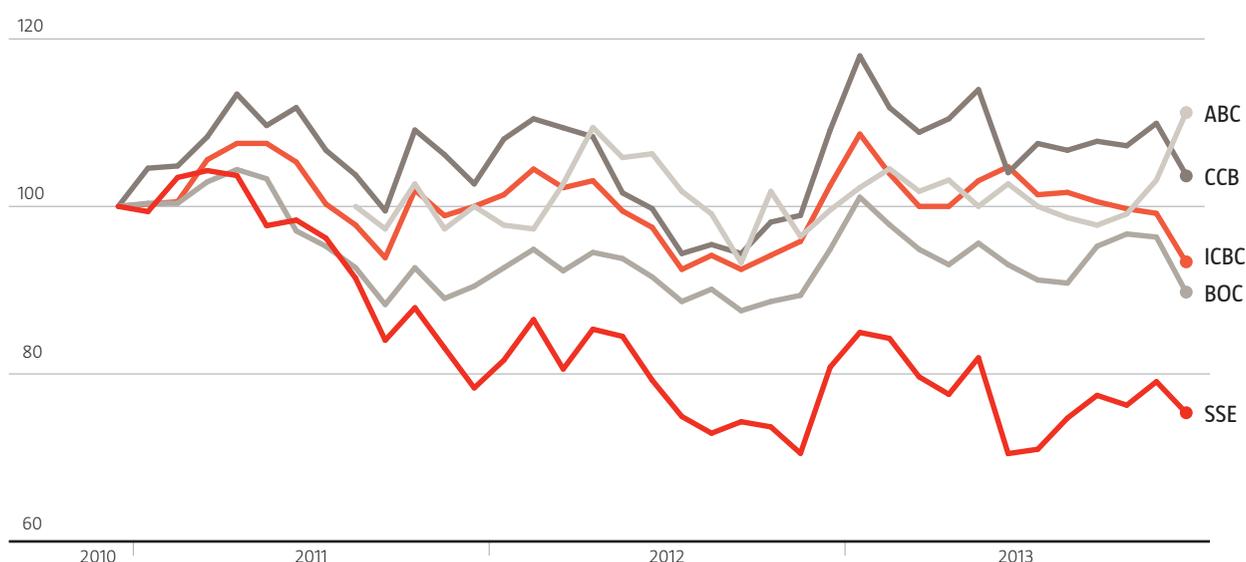
⁷ "China Central Huijin adds to Big Four bank stakes", MarketWatch, 17 June 2013 at <http://www.marketwatch.com/story/china-central-huijin-adds-to-big-four-bank-stakes-2013-06-17>

9. Looking Back and Launching Forward: SWF Investment in Financial Services

Chart 2

Relative Price Movement of China's Four Leading State-owned Banks (A-Shares) against the Shanghai Index (SSE)

Base year 2010 = 100



Source: Yahoo Finance (2014) and authors calculations.

The share prices of Chinese leading SOBs all experience positive price movements in the late spring in apparent response to the purchase programs, but underperformed the index (returning -1.6%) during the balance of 2013. While anecdotal, these share price movements suggest that discrete interventions by Huijin can in fact provide price support to share values of Chinese banks and as well may contribute to broader macro-economic policy objectives of the Chinese government related specifically to asset values⁸.

In sharp relief to Huijin, are the remnants of Ireland's National Pensions Reserve Fund (NPRF). The NPRF was established in 2001 to pre-fund social welfare and public service pensions of Irish citizens. For many years the NPRF maintained a broadly diversified portfolio of global securities. However, in 2009, in response to threats to the financial viability of Allied Irish Banks (AIB) and Bank of Ireland, the Funds, at the direction of the Minister for Finance, began to invest directly in both banks. In the intervening years, investments by the Fund in both banks have totaled €20.7 billion⁹. The first of these

investments - €7 billion – was used to acquire preference shares issued by AIB and Bank of Ireland in order to recapitalize them. In 2010 the NPRF participated in a share and rights issue of Bank of Ireland. Also in 2010 made a follow-on investment of €3.7 billion in the ordinary shares of AIB increasing its to 92.8%. In July 2011 an additional €10 billion was again made in both banks. In July 2012 began to trim some of its bank holdings. This continued in December 2013. However at year end 2013 of the nearly €20 billion in NPRF asset, over €13 billion remained committed to the Irish banking sector and specifically AIB and Bank of Ireland.

The Irish experience of SWF investment in financial services has indeed been transformative for the NPRF. In June 2013 the Irish government announced the establishment of the Ireland Strategic Investment Fund (ISIF). This newly created entity has absorbed the assets of the NPRF. Perhaps as importantly, its mandate, unlike that of a pension reserve fund, has been entirely restructured in order to contribute directly to promote economic activity and employment in Ireland¹⁰. Accordingly, the approximately €7 billion in fund assets not invested in banks will be directed to commercial investment opportunity *in Ireland itself*.

⁸ Definitive causal effects on the broader market in China related to the impact of SOB share purchases awaits a more robust analysis of joint share price movements.

⁹ See <http://www.nprf.ie/DirectedInvestments/directedInvestments.htm> for further details of the timing of the capital infusions.

¹⁰ See <http://www.nprf.ie/ISIF/IrishStrategicInvestmentFund.htm>

Even as the Irish government is forced to continually revisit its legacy investments in AIB and Bank of Ireland and their impact on its strategic objectives as global investor, it has launched ahead with a new investment program that over time will be financed in part by privatizing its strategic bank holdings. It is this strategic eye to the future, which also emerges as a second key theme in the investment activity of SWFs in 2013, focused not as in the past on developed market banks, but rather on emerging market financial institutions, specifically banks in South and Southeast Asia and Russia, and motivated by a steadily rising middle income families and an increased demand for housing and other forms of consumer finance. Several examples will serve to illustrate.

Investing on emerging markets financial institutions: Philippines, India, Cambodia and Russia

We begin with GIC in Singapore, who along with Temasek, have been active, knowledgeable investors in Asia for a number of years. In 2013, GIC combined with the Philippine conglomerate Ayala Corp to acquire 9.9% stake in Bank of the Philippine Islands from Singapore's DBS Group Holdings Ltd. The target is the third largest lender in the Philippines and the investment was valued at \$680 million, making it the largest banking deal in the Philippines since 2006. Under the structure of the co-investment, GIC will acquire a 5.6% ownership position in Bank of the Philippine Islands. Ayala, already a major shareholder in the bank, will increase its existing position by 4.3% to hold 48.3% in total. For GIC, the deal strengthens its position in the banking sector in Southeast Asia and allows it to access both the stability and potential growth rooted in the positive demographics of a rapidly growing middle class among its population of more than 600 million¹¹.

This Philippine deal complements a second Asia banking transaction completed by GIC in April 2013 in India. Heliconia Pte Ltd, an affiliate of GIC, subscribed to 20 million shares - about 2.6% of outstanding shares of Kotak Mahindra Bank at price of Rs 648 per share or a total of Rs 1,296 crore (\$237 million). The deal was intended to strengthen the bank's Tier I capital to position it to take better advantage of near-term growth opportunities¹².

Not to be undone, Temasek, Singapore's second wealth fund, likewise investment turned to the financial sector in Southeast Asia in what may have been its first deal in Cambodia. The SWF became a minority partner in commercial bank established in cooperation with Canadia Bank PLC and Cambodia's postal service. Temasek's investment was placed through its subsidiary - Fullerton Financial Holdings. Temasek, through Fullerton, was expected to holding a

45% stake in Cambodia Post Bank, while Canadia Bank will hold an effective majority 50% position¹³.

Lastly, we turn to Russia, where Qatari, Norwegian, Azerbaijani funds jointly participated in a \$3.3 billion offering by VTB, the proceeds of which the bank intends to invest to expand its domestic market share¹⁴. VTB, Russia's second-largest bank, is state-controlled. Together the SWFs - all from oil producing countries - contributed approximately \$1 billion of the new capital raised. While certainly not a transaction that would offer strategic diversification benefits, the deal rather was reported as motivated as a proxy, i.e. a channel through which to gain increased exposure to Russia's positive demographics: 140 million rising middle class consumers¹⁵.

Conclusions

We close here with a brief reflection on an important, but sometimes neglected link between SWFs and the global financial services industry: capacity building. In 2013 there appeared an increased number of reports that SWFs had begun more actively to move away from civil-service pay structures - higher base pay versus bonuses - and were changing compensation schemes to more effectively compete with international financial services firms for top banking talent.¹⁶ Despite being both clients to and competitors of global financial institutions, it is often easy to overlook the expanding network effects of SWFs as they become even more integrated into the fabric of global finance. Whether through enhanced training, relationships with investment partners, co-investment or employment mobility, many SWFs took another step forward in 2013 to build and acquire the advanced capacity that will serve them well as strategic global investors, particularly in banking and finance.

The financial services investment activity by SWF in 2013 was marked as a year of growth and increased sector penetration that reflected legacy themes, but also a launch forward into new regions, motivated in part by positive outlooks for growth spurred by advancing socio-economic demographics. Certainly, for some sovereign investors, strategic objectives remain very much centered on preserving domestic financial stability and strengthening the foundations of their domestic banking systems. However, as the negative effects of the GFC slide further into our past, the question of SWF strategic engagement in financial services takes on new meaning. Rather than rescue and recapitalization, perhaps the time is soon approaching to focus on innovation and growth.

¹¹ "GIC, Ayala Pay \$680 Million for Philippine Bank Stake", Wall Street Journal, 11 November 2013 at <http://online.wsj.com/news/articles/SB10001424052702304644104579192802149415082>
¹² "Kotak Mahindra Bank gains on preferential issue to Heliconia", Business Standard, 12 April 2013 at http://www.business-standard.com/article/markets/kotak-mahindra-bank-gains-on-preferential-issue-to-heliconia-113041200215_1.html

¹³ "Singapore Invests in New Cambodian Bank", The Cambodian Daily, 11 September 2013 at <http://www.cambodiadaily.com/archives/singapore-invests-in-new-cambodian-bank-42137/>
¹⁴ "Russia's VTB wins sovereign backing for \$3.3 billion share issue", Reuters, 29 April 2013 at <http://www.reuters.com/article/2013/04/29/us-russia-vtb-idUSBRE93S04820130429>
¹⁵ Ibid.
¹⁶ See <http://news.efinancialcareers.com/us-en/150642/working-for-a-sovereign-wealth-fund-has-the-potential-to-be-extremely-lucrative/>