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Sovereign wealth fund governance and national culture☆

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ABSTRACT

As sovereign wealth funds (SWFs) are owned and directed by sovereign governments which often have non-economic strategic motives and concomitant lack of transparency, there is much confusion, suspicion, and concern regarding the purpose of their investments. Strategic or non-economic motives for SWF investments are usually conveyed via respective governing boards of directors. Therefore, there is much need for understanding SWF governance. Using data for 49 large SWFs globally, we document significant and economically important evidence of the impact of national culture on SWF governance. Even when controlling for the quality of respective national governance, we find that poorer SWF governance is associated with the cultural dimensions of power distance, individualism, and most likely masculinity; while better SWF governance is associated with long-term orientation, indulgence and uncertainty avoidance. These results are consistent with what others have noted: good governance means different institutional dynamics in different countries (cultures). We also find that SWF governance is negatively associated with greater investment in foreign assets. Policy makers, capital-market participants, and managers will be interested in these results, as SWFs have become large and important global investors.

1. Introduction

Sovereign Wealth Funds (SWFs) are one of the largest institutional portfolio investors in the world and are growing rapidly with their total size projected to rival the combined capitalization of all NYSE firms later in this decade (Bagnall & Truman, 2013). Recent estimates indicate that SWFs hold an aggregate US $9 trillion in invested funds (Jaye, 2016). Due to their enormous size and scope, and consequent power, SWFs are increasingly important not only for their impact on global finance but also for their geopolitical and social consequences (Aizenman & Glick, 2009).

In general, there are two types of SWFs: those funded by excess foreign currency reserves because of commodity exports, or general trade surplus; and those funded by public pension assets. In part because of their funding, SWFs are fundamentally different from privately owned investment firms. With regard to SWFs, the respective government's intentions may not be readily discernible. Owners and managers of SWFs often have non-pecuniary motives such as domestic political-social concerns; as well as strategic international political, social, and military concerns. SWF management may include goals and concerns beyond modern portfolio management that include motives to serve the strategic needs of the respective owning country such as national resource or military needs or acquisition of technology (Knill, Lee, and Mauck, 2012a; Summers, 2007).

Such strategic or non-economic motives for SWF investments are usually conveyed by governments to SWFs via the SWF governing board of directors, as this group controls how SWF assets are deployed or distributed. Consistent with this generally accepted understanding, governance is defined in this paper as the set of formal and informal rules of the game regulating and directing with transparency the deployment and distribution of organizational resources.

As SWFs frequently lack transparency and are controlled by governments, often with non-economic and strategic motives, there is much suspicion, concern, and confusion regarding the governance and investment purposes of SWFs (Mattoo & Subramanian, 2009). According to Kotter and Lel (2011), "SWF objectives and behavior are not well understood. In particular, the foreign government ownership of these investment funds coupled with the opaqueness surrounding their structure and activities are among the major concerns in host countries including the United States."

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In spite of this apprehension and concern about SWFs, there is little prior research on the determinants of SWF governance. Further, while there have been many studies of the macroeconomic and political impacts of SWF investment policies, there seems to be no specific study of the determinants of SWF governance. In addition, despite prior research on the role of national culture in determining accounting transparency, disclosure, and governance (e.g., Gray, 1988; Guiso, Sapienza, and Zingales, 2006; Jaggi & Low, 2000), little previous research has applied such findings to investigate the determinants of SWF governance and how it might be related to national culture, institutions, and SWF characteristics. It is not just policy makers and investors, but also corporate managers and their boards that need to understand such determinants. Such understanding is necessary for effectively assessing and negotiating potential SWF investments. Consequently, studying the determinants of sovereign wealth fund governance is important and can yield critical insights for policy-makers, capital markets, corporate managers, and investors.

Using data on 49 large SWFs from 33 countries and controlling for relevant variables, this paper examines national institutions, culture, and SWF characteristics as determinants of SWF governance. We evidence, importantly for the first time, that national culture matters greatly in determining SWF governance. Specifically, in addition to a few other expected variables, we evidence a negative association of SWF governance with the national cultural dimension of power distance and individualism; and a positive association with the national cultural dimensions of long-term orientation and uncertainty avoidance. There is also a somewhat weaker evidence for a positive association with masculinity.

2. Theoretical background and hypotheses

2.1. Importance of SWF governance

While SWFs have existed since the 1950s, they have recently been attracting greater attention due to rapid growth. Bagnall and Truman (2013) and others confirm that SWFs are a large and important component of international portfolio investment (e.g., Beck and Fidora, 2008; Chhaochharia and Laeven, 2008; Johnson, 2007; Kotter and Lel, 2011; Megginson, Bortolotti, Fotak, & Miracky, 2009). With total assets now over $9 trillion (Jaye, 2016), SWFs assets are already more than twice as large as the global pension fund industry.

In many ways, rising investments by SWFs are part of a larger trend of state-owned companies and other state entities investing in foreign private companies. Indeed, SWFs are often depicted primarily as professional investment management firms with specific missions and investment objectives, including the delivery of high investment returns from diversified international portfolios. However, as state-controlled investment funds, SWF also reflect issues similarly identified with the significant state ownership of private corporations. For instance, Chen et al. (2017) find that investment sensitivity is reduced with state ownership. Boubakri, Cosset, and Saffar (2013) find that government ownership of private corporations depresses respective risk taking. Bortolotti, Fotak, and Megginson (2015) find government ownership hurts firm value and performance

Once again, governance is defined in this paper as the set of formal and informal rules of the game (and their transparency) regulating and directing the deployment and distribution of organizational resources. Research examining the association of SWFs and governance is closely related to the broader research stream that examines the association of government ownership and governance. Generally, such research finds that investor protection is diminished by state ownership (La Porta, Lopez-de-Silanes, and Shleifer, 1999). Other research finds the impact of state ownership on governance is shaped by legal origin (La Porta, Florencio Lopez-de-Silanes, & Vishny,1998). In particular, Borisova et al. (2012) find that for a sample of firms from the European Union that government ownership is associated with lower governance quality when the country has a civil-law legal origin and a positive association with governance when it has a common-law legal origin.

However, the determinants of SWF governance, particularly cultural impacts, have not been investigated. The impact of culture on SWF governance, in particular, is likely related to but also distinct from the impact of culture on governance in general. This is because culture can shape outcomes both directly and indirectly through first shaping institutions related to governance in general. The pathways of culture's impact are nuanced and reflect the structure and nature of these respective institutions.

Further, while government ownership of state-owned enterprises has been found to be associated with a decline of corporate governance, increased deficiency of board performance evaluation, fewer criteria for board appointment, and less balance of executive directors and non-executive directors, the determinants of the governance of SWFs as wholly government-run entities is a very different investigation. As all SWFs are controlled by governments, it is more likely that national culture will impact governance of SWFs than it will the governance of private firms. This is also because the impact of culture on the governance of private firms is likely confounded by varying levels of institutional, family, and block ownership and other private market influences.

While SWFs obviously share similarities with state-owned enterprises, they are also unique in many respects. For instance, many question the purpose of SWF investments given the mixed economic and strategic goals of their ultimate sovereign owners (Bahgat, 2008). Others, including western regulatory authorities, have called for greater SWF transparency (Gieve, 2008). SWF objectives are likely not universal, especially as SWFs often also have important geopolitical and social goals (Aizenman & Glick, 2009). Therefore, it is quite possible that while national culture might influence systematically general inclinations for governance in respective countries, the manner in which national culture will particularly influence the governance of SWFs may be much more nuanced.

2.1.1. Santiago principles, governance, and culture

In October 2008, in order to address concerns and suspicions regarding SWFs, the Generally Accepted Principles and Practices governing SWFs ("Santiago Principles") were issued by the International Working Group on Sovereign Wealth Funds. These principles are seen as a positive way of promoting understanding and transparency of SWFs. Nevertheless, many continue to question the impact of the Santiago Principles going forward, mainly due to their voluntary nature and broad grouping of heterogeneous SWFs. In addition, most SWFs have made little progress towards meeting the Santiago Principles (Truman, 2013). An outline of the Santiago Principles is presented in Appendix B.

We consider Santiago Principles 1, 2, 4, 15, and 16 to be particularly relevant to this study as they relate to disclosure and governance. However, all of the Santiago principles relate to governance, disclosure, and transparency. For example, Principle 1 states that the legal framework for the SWF should be disclosed and be sound and support effective operation and the achievement of its stated objectives. There is much evidence that this is not observed to the same extent in all countries. The second principle states that the policy purpose of the SWF should be clearly defined and publicly disclosed. Principle 4 states that there should be clear and publicly disclosed policies, rules, procedures, and arrangements in relation to the SWF's general approach to funding, withdrawal, and spending operations. Clearly the Santiago Principles place much emphasis on the legal standards and disclosures of SWF governance; but these principals are observed only with varying degrees by different SWFs.

In continuation, we maintain that national culture will also have a significant role with regard to the implementation of the Santiago Principles and governance of SWFs. We note it has been suggested by many scholars (e.g., Tabellini, 2010) that deep-seated cultural values