CFORUM.ET

SOVEREIGN WEALTH FUNDS AND THE ESTABLISHMENT OF ETHIOPIAN INVESTMENT HOLDINGS

By: Thomas Mulugeta

OCTOBER 13, 2022

SOVEREIGN WEALTH FUNDS AND THE ESTABLISHMENT OF ETHIOPIAN INVESTMENT HOLDINGS

By Thomas Mulugeta
Partner | HST

The Financial Times, on its edition on 27 February 2022 wrote an article on the Ethiopian government's attempt to attract new investments by using a newly introduced vehicle, A sovereign wealth fund called Ethiopian Investment Holdings (EIH).

The challenges faced and the downturn of the county's economy is no news. These challenges coupled with the government's policy shift from a developmental state model to private sector driven reform, initiated this model of using a state-owned investment fund as a vehicle to drive the economy forward.

The government aims to attract investors mainly to state-owned companies and assets worth up to USD150bn, according to the Financial Times.

Sovereign wealth funds have recently been one of the most sought after means of attracting investments by many countries around the world as well as in Africa. Ethiopia joins 24 countries in Africa who established sovereign funds over recent years, the torch bearer being Botswana in 1996.

Governments around the world started establishing Sovereign Wealth Funds (SWF) from the early 1980s. However, the real growth in their numbers and the value of assets they manage, happened between 2003 and 2013. Now, sovereign funds in countries like China, Norway, UAE, Kuwait and Singapore have some of the highest value of total assets. SWFs of nations in the Middle East, for instance, were set up to invest the windfall that these countries gained from the oil boom in the middle of the twentieth century.

Ethiopia

The establishment of the Ethiopian Investment Holdings (EIH) in December 2021, emphasized the government's intentions to closely manage the country's most valuable and critical categories of assets. And as can be seen from the main objectives of the EIH, Ethiopia needed to endeavor to develop the country's economy sustainably, manage funds professionally and be a strategic vehicle for foreign investment and maximize the values of the country's assets through what it called ‘strategic investment arm of the government’.

Sovereign wealth funds such as the Ethiopian Investment Holdings (EIH) can be generally funded by balance of payments surpluses, official foreign currency operations, proceeds of privatizations, governmental transfer payments, fiscal surpluses and/or receipts resulting from resource exports. Such establishments help stimulate the investment needs of the country while at the same time help bring out sectors with potential growth opportunities.

From the onset, the major source of fund of EIH seems to be proceeds of privatizations. With the introduction of a capital market around the horizon, one of the main objectives of Ethiopian Investment Holdings (EIH) is, among other goals, to take part in capital market, money market and similar other sectors through purchase, sell or other investment undertakings. This may make EIH a significant player in investing resources, to be acquired from proceeds of sales of some of the country’s lucrative assets.

The size of resources and assets that sovereign funds manage are usually immense. These resources are acquired from privatization of companies and assets, trade surpluses, excess foreign currency reserves, lucrative proceeds from oil and minerals, etc. It has been clear that the Ethiopian government’s intentions aim at generating significant proceeds from partly or wholly privatizing some of the country’s leading institutions. These proceeds can be reinvested as the government sees fit.

However, there have been concerns around the world about lack of transparency and governance on most sovereign wealth funds, which triggered the development of SWF scoreboards and indices by different experts to assess the transparency and accountability of these funds guided by basic principles called ‘The Santiago principles.

‘The Santiago principles’

In 2008, representatives of the international Monitory Fund (IMF) and major sovereign wealth fund establishments and their respective states drafted a set of principles on the governance, accountability, and transparency of SWFs. The International Working Group of Sovereign Wealth Funds (The IWG) comprising 26 IMF member countries with SWFs met on three occasions—in Washington D.C., Singapore, and Santiago (Chile)—to identify and draft a set of Generally Accepted Principles and Practices (GAPP) that properly reflect their investment practices and objectives. And at its third meeting, the participants agreed on the Santiago Principles.

The GAPP were designed to enable SWFs, especially newly established ones such as the EIH, to develop, review, or strengthen their organization, policies, and investment practices.

The generally accepted principles and practices (GAPP) drafted by the IWG, is underpinned by the following guiding objectives:

1. To help maintain a stable global financial system and free flow of capital and investment.
2. To comply with all applicable regulatory and disclosure requirements in the countries in which they invest.
3. To invest based on economic and financial risk and return-related considerations; and
4. To have in place a transparent and sound governance structure that

provides for adequate operational controls, risk management, and accountability.

The IWG, in its publication to explain the GAPP in 2008, recognized that the principles and practices are subject to provisions of intergovernmental agreements, and legal and regulatory requirements. Thus, the implementation of each principle of the GAPP is subject to applicable home country laws both at what it calls 'home country' the home of the SWF and 'recipient country', the country where the SWF invests.

These principles and practices also provide guidance on how to align each government's investment policies with the existing opportunities in other countries and most importantly investing professionally in accordance with their investment policy objectives—and to help inform any associated legal and institutional reform. The guidance also helps to comply with applicable regulatory and disclosure requirements in their home countries and in the countries in which they invest.

Out of the above four guiding objectives, I want to emphasize on the final one and from Ethiopia's context I consider it as the most critical. Governance and transparency are at the forefront of any institution's basic requirements. Particularly those that run public resources, key assets and investments by states and governments.

In a policy brief published in February 2021, Petersen Institute for international economics expressed their concern, emphasizing on increased public scrutiny over activities and operations of Sovereign Wealth Funds. These concerns included investment patterns, financial results, and governance.

The potentially distorting impact of SWFs on the economies of countries that owned them was also a source of concern, raising questions about their transparency, governance, and possible politicization.

Transparency

One of the key challenges faced by sovereign funds around the world is lack of transparency. Sovereign wealth funds in some countries are not as transparent as in others. Although this issue has significantly improved since 2008, some funds still tend not to disclose their performance to the level necessary. A number of efforts have been made by various bodies to measure the level of transparency of mainly Government owned strategic sovereign wealth funds and find ways of improvement in reporting and disclosures.

Two of the most notable ones are the Linaburg-Maduell transparency index and The Truman index (Scoreboard) which are methods of rating transparency and other key aspects such as governance and investment decisions with respect to sovereign wealth funds mainly focusing on government-owned investment vehicles, where there have been concerns of unethical agendas. Calls have been made to the non-transparent funds to show their intentions.

These indices of rating transparency were developed in 2008 and 2007 respectively and have since been used worldwide, by sovereign wealth funds in their official annual reports and statements. As one of the global standard benchmarks, the Truman scoreboard being a prototype scoreboard, has also been rating the transparency and accountability of SWFs.

These indices are based on essential principles that depict sovereign wealth funds' transparency to the public.

The indices and scoreboards used a number of principles through which they can measure key areas of transparency like the following, the majority of which are taken from the Santiago principles.

- History including reason for creation, origins of wealth, and government ownership structure
- Up-to-date independently audited annual reports
- Ownership percentage of company holdings, and geographic locations of holdings
- Total portfolio market value, returns, and management compensation
- Guidelines in reference to ethical standards, investment policies, and enforcer of guidelines
- Clear strategies and objectives
- The fund clearly identifies subsidiaries and contact information

The SWF scoreboard by Truman suggests that many countries are not institutionally committed to reporting withdrawals from their funds. Of the 64 funds on the 2019 scoreboard, 28 (44 percent) do not clearly identify the source of financing or the guidelines or rules for withdrawals. Information on withdrawals or the use of the earnings of the fund is often not accurate.

Governance structure

The International Working Group of SWFs also indicated that the practices and principles try to address the following three key areas.

(i) legal framework, objectives, and coordination with macroeconomic policies.
(ii) institutional framework and governance structure; and
(iii) investment and risk management framework.

As an SWF, Ethiopian Investment Holdings needs a robust institutional framework and governance structure and facilitate formulation of appropriate investment strategies consistent with the Country's stated policy objectives. The GAPP under the Santiago Principles also gives guidance to carefully set up governance structure that separates the functions of the owner of the holding company and the governing body.

The principles also try to guide management to facilitate operational independence in the management of the funds to pursue investment decisions and investment operations free of political influence. A clear investment policy shows an SWF's commitment to a disciplined investment plan and practices. Also, a reliable risk management framework promotes the soundness of its investment operations and accountability.

The SWF should have a framework that identifies, assesses, and manages the risks of its operations.

Most of the fastest growing funds and those that mange high value assets have been companies that have sources of financing from natural resources such as oil and mineral. However, in terms of the numbers of funds entering the market, there has been a shift away from natural resources toward budgetary funds and holding companies and similar structures. This shift is a positive news to EIH.

Conclusion

I am of the view that the EIH and Ethiopia at large, have a late comer's advantage. EIH has all the experience of others to learn from. Particularly from those funds and countries that have similar stature, challenges, and economic backgrounds like Ethiopia.

As studies such as that of the Petersen Institute for International Economics concluded that SWFs have shown considerable improvements in their scores over transparency and governance over the past few years, which can be a very good experience for EIH to learn from.