Insurance companies are attractive targets for sovereign wealth funds looking to establish global financial centers in their home countries.

SOVEREIGN WEALTH FUNDS (SWFs) have been hard to ignore since they started investing in beleaguered banks in late 2007. Funded predominantly by Middle Eastern oil money and Asian export revenues, their highly visible investments in the U.S. financial services industry, coupled with concerns about the transparency of their investment strategies, have kept them squarely in the limelight.

STRATEGIC

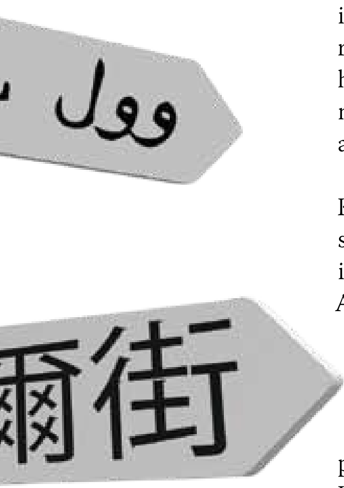
BY JOE GUASTELLA, PRITI RAJAGOPALAN, AND SUNIL RONGALA, WITH RYAN ALVANOS

When foreign exchange flows into a country, it typically accumulates in the reserves of the central bank, which holds it in the form of low-yield assets such as government securities (e.g., U.S. or Euro treasuries). These inflows can sometimes create inflationary pressures by increasing the money supply, and the opportunity cost of holding low-yield assets is high. Thus, some governments use SWFs to invest in a variety of financial instruments that earn higher risk-adjusted returns. Further, many governments have created SWFs as vehicles for making investments that diversify their risk or serve as a hedge against their primary source of revenue.

The first major SWF was established in 1953 in Kuwait. Approximately three dozen exist, and a substantial part of these funds comes from oil revenue, including the largest one, the Abu Dhabi Investment Authority. Nevertheless, SWFs are only in their infancy as key players in financial markets. Their $2 trillion to $3 trillion value pales by comparison to other major players like insurance companies, mutual funds, and pension funds (based on comparisons to asset values estimated in April 2008 by International Financial Services London). However, they may be poised for explosive growth: In a September 2008 speech, John Lipsky, first deputy managing director of the International Monetary Fund (IMF), said that SWFs may reach $7 trillion to $11 trillion by 2013. It's important to note, though, that estimates may change over time, as they are largely dependent on the price of oil and other commodities.

While some SWFs have adopted a conventional or passive approach to their investments, others strive for strategic advantages beyond a mere rate of return. They know that luring a target firm's regional headquarters; operations; or its technology, innovations, or intellectual property can significantly enhance local business infrastructure. As such, the pursuit of these types of positive externalities focuses SWF investments on sectors like telecommunications, energy, and financial services that can bolster the funds' home economies. In an October 2007 report, Gerard Lyons of the London-based Standard Chartered Bank wrote, "The economic rationale behind such strategic acquisitions [of stakes] is clear. Some countries may see this as a way to move up the value curve quickly, as they acquire intellectual property and access to research, design, and development that may take years to develop at home."

Between March 2006 and February 2008, 14 of 15 SWF deals involved financial services organizations: Stock exchanges, hedge funds, private equity firms, and banks were all involved in mammoth deals that ranged in value from $1 billion to $13 billion. SWFs have sometimes been viewed with concern by Western politicians and media. But even after acquiring large stakes in target firms, SWFs don't look much like



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INVESTMENT

The Role of Insurance in Emerging-Market Makeovers

Top Sovereign Wealth Funds

Sovereign Wealth Funds	Assets ($ billion)	Year of Inception
UAE: Abu Dhabi Investment Authority	875.0	1975
Norway: Government Pension Fund-Global	380.0	1996
Singapore: GIC	330.0	1980
Saudi Arabia: Various	300.0	NA
Kuwait: Reserve Fund for Future Generations	250.0	1953
China: China Investment Corp. (CIC)*	200.0	2007
Singapore: Temasek Holdings	159.2	1974
Libya: Oil Reserve Fund	50.0	2005
Qatar: Qatar Investment Authority	50.0	2005
Algeria: Fond de Régulation des Recettes	42.6	2000
U.S.: Alaska Permanent Fund Corp.	38.0	1976
Brunei: Brunei Investment Authority	30.0	1983
Other	171.4	
Total	**2,876.3**	

*Includes Central Huijin Investment Co. The CIC is the umbrella organization.

Note: Much variation surrounds the estimation of SWF assets.

Sources: Morgan Stanley (as reported in "Asset Backed Insecurity," *The Economist*, Jan. 17, 2008) and Deloitte Research, "Insurance Firms: The Missing Link in the Sovereign Wealth Fund Acquisition Spree," July 21, 2008.

the archetypal corporate raider. In fact, many of their buys have been friendly in nature; board representation and management demands haven't factored significantly into these transactions. In May 2007, for example, China Investment Corp. agreed to purchase $3 billion in non-voting shares when it acquired an almost 10 percent stake in Blackstone Group, concurrent with Blackstone's initial public offering. Similarly, in January 2008, Temasek increased its stake in Standard Charter PLC to about 19 percent and didn't ask for a board seat. Additionally, the development of the "Santiago Principles" with the assistance of the IMF is likely to have a positive impact in mitigating concerns about SWF transparency and disclosure.

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Developing Financial Hubs

The affinity of SWFs for financial services targets has its origins in the desire for economic progress. Many countries with large SWFs, such as United Arab Emirates, Qatar, and China, have the ambition to develop world-class financial centers that can rival New York, London, or Tokyo. While transforming these locations into global financial hubs is a long-term dream at present, becoming a regional financial powerhouse may be an imminent reality. Economic grounding of this magnitude would also enable these cities or countries to diversify away from their primary sources of revenue.

Often overshadowed by Dubai, the much richer Abu Dhabi, capital of the United Arab Emirates, has very serious plans to develop itself as a global financial center. In March 2008, the Abu Dhabi Securities Market entered into an agreement with NYSE Euronext to "jointly develop and explore new opportunities in trading systems and other related technology, investor and issuer services, and investment products… with state-of-the-art information and market infrastructure systems and technology to host all financial instruments admitted to trading on ADSM." In addition, Abu Dhabi lured the Royal Bank of Scotland to centralize its regional operations in the emirate.

Just 90 miles away, Dubai is also nursing ambitions to develop a global financial center. To this end, it constructed the Dubai International Financial Centre (DIFC) on a 110-acre free zone to create, as it says on its website, "a regional capital market, offering investors and issuers of capital world-class regulations and standards." Financial services companies play a pivotal role in Dubai's growth strategy, and the DIFC has attracted some of the world's largest hedge funds, private equity firms, and banks.

Doha, the capital city of Qatar, is another competitor in the race to establish a global financial center in the Middle East. While it currently lags behind the wealthier cities of Dubai and Abu Dhabi, the Qatar Financial Centre, according to its website, "is designed to attract international financial institutions and multi-national corporations to establish business operations in a 'best-in-class' international environment."

Similar to the Middle East, China is trying to diversify away from the manufacturing sector and establish Shanghai as a world-class financial center. To reinforce the image of its vaulted financial ambitions, Shanghai opened the Shanghai World Financial Center, a 101-story building, in August 2008. In fact, Shanghai is competing with Hong Kong to become the financial capital of China. In a Jan. 16 article, *New York Times* reporters Keith Bradsher and David Barboza observed, "Hong Kong and Shanghai are not just competing with each other—they are also vying with Tokyo and Singapore to become the most important financial center in Asia."

Insurance: the Missing Piece

But world-class financial centers require more than banks, hedge funds, and private equity firms. Insurance companies are also an important and necessary constituent. Using SWFs to buy large stakes in this industry could further bolster foreign governments' ambitions to develop world-class financial centers.

The insurance industry historically has played an integral role in the development of financial markets and broader economic activity by transferring risk within an economic system. As emerging economies experience growth, commercial property and casualty (P&C) insurance protects them from risks associated with the creation of new wealth. And reinsurance can help insurers manage the new risks they absorb. Thus, the development of other insurance lines serves to bolster reinsurance activity, which, in turn, allows insurers to provide greater levels of economic protection than their assets would otherwise allow.

Meanwhile, demand for personal lines of insurance typically grows as economies emerge and populations begin to look for psychological and financial security. On the P&C side, insurance companies can provide general liability, auto, home, and other types of insurance that correlate highly with increased purchasing power. Finally, insurance companies play a major role in providing funds to capital markets. As insurance companies grow, they may reinvest their capital into the stock and bond markets, thereby fostering additional growth throughout the economy.

Spillover Benefits

In the Middle East, insurance markets are often underserved, fragmented, unsophisticated, and undercapitalized. Similarly, in China, the insurance industry is undercapitalized and faces a severe talent shortage. As these governments try to close the gap between the state of their financial sectors and that of their world-class counterparts, SWFs will most likely seek externalities that can be attained through investments in Western insurance companies dealing in reinsurance, commercial P&C, life, and personal lines. However, insurance markets in the Middle East are very different from those in China, and SWFs from these regions will target different externalities.

Insurance penetration in the Middle East and Asia is significantly lower than the averages for industrialized countries, but both markets are poised for growth. In the Middle East and North Africa, macroeconomic progress, the emergence of compulsory insurance classes, the privatization and restructuring of government pensions, and the growth of financial services will collectively contribute to fuel high growth rates. Unfortunately, local insurance companies are not in a position to meet the needs of this underserved population. Markets are fragmented; existing companies are too specialized and undercapitalized; skills and resources for more sophisticated lines are limited; and more complex insurance lines like aviation and energy are unavailable. In China, a weak social security system, aging population, lack of alternative savings vehicles, and economic reform programs will play a role in the

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growth of insurance markets. Big state-owned companies dominate China, and though they are growing at around 20 percent per year, they may not be able to compete with the cutting-edge operations and innovations of their counterparts in the West.

As such, the quest for spillover benefits like luring Western companies to set up local headquarters or operations is prompting certain Middle Eastern cities and countries to establish proper rules and regulations, legal services, infrastructure, and talent to support incoming companies from abroad and, by extension, economic growth. For example, according to *Condé Nast Portfolio*, Dubai plans to grow into a regional transportation and entertainment hub by investing in the expansion of a $1.2 billion port system, an $82 billion airport and aerospace infrastructure, a $3.8 billion metro system, and a $5 billion SWF investment in the MGM Mirage.

But for China, its market potential alone is enough to attract foreign companies, and state-owned companies already provide many products and services. Most major insurance companies have a presence in China, but the combined market share of these companies, including joint ventures, is only around 4.6 percent according to the *Economist Intelligence Unit*, a London-based provider of country, industry, and management analysis. Thus, acquiring know-how for state-owned companies, rather than luring foreign companies, would be China's primary external benefit sought from investments in Western insurance companies.

Through these externalities, SWF investments would very likely bring substantial changes to the scope and complexity of insurance products offered to commercial and personal clients in these markets. It's worth noting that when targeting Western companies, SWFs have been hesitant to make outright purchases, which would require increased disclosure, potentially trigger a political and regulatory backlash, and engender negative publicity. The difficulty in acquiring talent to build insurance companies from scratch will also pose substantial barriers for SWFs seeking to launch their own reinsurers or other types of insurance companies. Thus, SWF investments in Western insurance companies serve as a practical route for advancing insurance services in the Middle East and Asia.

In the meantime, insurance companies should begin thinking about the potential problems and benefits that may arise from an SWF investment. SWFs could offer insurance companies quick, large-scale capital infusions with few strings attached. Additionally, SWFs typically have long investment horizons and little desire to get involved in the day-to-day management of companies. It's also possible that Middle Eastern and Chinese SWF investments could facilitate the improved market position of American and European insurance companies in these emerging markets. ●

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