

# Rebalancing the geographies of financial services power: the role of sovereign wealth funds

**James Faulconbridge**

Geography, Lancaster Environment Centre, Lancaster University, Lancaster, LA1 4YQ, UK

Email: [j.faulconbridge@lancaster.ac.uk](mailto:j.faulconbridge@lancaster.ac.uk)

Published in *Environment and Planning A*, 42, p2280-2283

## Introduction

As part of debates about the causes, consequences and political ramifications of the credit crisis and ensuing recession (for a summary of which see Engelen and Faulconbridge, 2009), questions about the changing geographies of power in the financial services sector have elicited interest both in academic and media circles in recent years. Aalbers (2009, 39) suggests that we are witnessing a change in the powerfulness of incumbent financial centres such as London and New York as a multi-polar world emerges in which the Middle East – the United Arab Emirates, Saudi Arabia, Qatar etc. – and Asia – China in particular – and their respective financial centres increasingly play bigger and bigger roles in financial services activities. Similarly the newspaper of the City of London – City AM – reported that a shifting balance of power as a result of the financial crisis and the simultaneous growth of new financial centres means the City can no-longer be sure that its preeminent position in the global ‘pecking order’ is secure (see Hazelhurst, 2009). Indeed, in the 2009 edition of the annual Global Financial Centres Report (see City of London Corporation, 2009) it was reported that, whilst London remained atop of the rankings of financial centres, new challengers had quickly risen up the table in the period 2008 to 2009.

Challengers include Singapore (32 places rise in ranking), Shanghai (117 places rise), Beijing (135 places rise), Dubai (37 places rise), Seoul (114 places rise) and Qatar (51 places rise) alongside some significant new entries into the top 75 including Riyadh.

In this context, studying sovereign wealth funds (SWFs) can tell us a lot about the financial services sector. Specifically, in this commentary I suggest that studying the reactions of financial service providers, such as asset managers but also the broader complex of professional services such as accounting and law that 'lubricate' (Dicken, 2007) the financial system, to the growing importance of SWFs reveals much about the dynamics of the changing geographies of power in the financial services sector and the implications for incumbent financial centres such as London and New York. I make two main points. First, I suggest that the growing importance of SWFs does indeed mean that financial centres such as Doha, Dubai and Shanghai will become increasingly powerful over the coming years, in particular as financial service providers such as asset managers and related professional service firms such as law race to establish new and grow existing operations in these centres. Second, however, I also contend that this rebalancing of power relations will not be a zero sum game that necessarily leads to the erosion of the power and importance of incumbent centres such as London and New York. By taking a relational approach to understanding the geography of financial centres (on which see Beaverstock et al., 2006; Faulconbridge, 2004) that recognises the complementary nature of coexisting centres (on which see Clark, 2002) I illustrate the way that incumbent centres are actually likely to benefit from the activities of SWFs and the growing importance and power of centres such as Doha, Dubai and Shanghai .

I develop these arguments over three further sections. First I examine the geographical implications of the rise and evolution of SWFs. Second, I then consider the way the 'new' financial centres associated

with the home-countries of SWFs, centres such as Doha, Dubai and Riyadh, actually generate new opportunities for incumbent centres such as London and New York to sustain their role and powerfulness in international finance. The final section concludes by considering the broader implications for understandings of the geographies of power in the financial services sector.

### **The rise, evolution and investment practices of SWFs**

According to Aizenman and Glick (2008), the six biggest SWFs possess 75 percent of all of the assets held by SWFs worldwide and, with the exception of the Norwegian fund, all of these are from the Middle East – United Arab Emirates, Saudi Arabia, Kuwait – and Asia – Singapore and China. At present, the role of SWFs in financial markets, said to be around four percent of all global assets under management totalling US\$3800 billion, is relatively limited when compared to pension funds (25 percent) and insurance funds (17 percent) (see IFSL, 2009). However, it is predicted by some that by 2020 SWFs will represent 15 percent of all assets under management (Aizenman and Glick, 2008).

At first glance, then, the size of the assets of SWFs and their potential future role as actors in financial markets seems to suggest that a new multi-polar world in which the preeminence of incumbent centres such as London and New York is threatened is likely to emerge in the next decade. As sites of investment activity, Dubai, Riyadh, Kuwait City, Singapore and Beijing and Shanghai are likely to grow in importance, not least because of the domestic investments of SWFs. For example, Bortolotti et al. (2009) report that in 2008 22 percent of SWFs' investments were in their home countries whilst the profits made by SWFs are often ploughed back into domestic investments, one implication being, as Diwan (2009) notes, that

HSBC now estimates one third of all project finance initiatives to be in the Middle East. At the same time many of the SWFs from the Middle East invest in their neighbour countries, the United Arab Emirates having received over US\$14 billion in investment from SWFs (Bortolotti et al., 2009). When coupled to the growth in non SWF investments being channelled through new financial centres such as Doha and Dubai this is making financial services activity in such centres of growing importance, drawing in financial institutions, private equity and hedge funds and related professional services.

Confounding the impacts of the rise of SWFs on the growth of financial centres until recently off the map of global finance are the widely acknowledged differences in the investment practices and governance regimes of SWFs compared with the practices and governance of Anglo-American investors (see Aizenman and Glick, 2008; Clark and Monk, 2009; Monk, 2009). SWFs are known to be risk averse, hence their historical preference for government bonds. However, from a position where government bonds dominated SWFs' investments a picture is emerging of funds that are diversifying into, amongst other things, equities, commodities and real estate. As a result, Beck and Fidora (2008) suggest that the UK – i.e. London – is likely to see around US\$1 billion of outflows of SWFs assets from bonds but an almost equal inflow of SWFs assets into equities over the next ten years. This gradual switch towards investments in equities, real estate etc. that do not have guaranteed returns means the managers of SWFs increasingly require trusting and close relationships with asset managers, lawyers and other professional advisors (Clark and Monk, 2009). Indeed, reflecting the origins of many SWFs in the Middle East and Asia where both the cultures and norms of business are different to those of the Anglo-American world (on which see Yeung, 2000), SWFs insist on long-term relationships with the professionals they employ built on personal friendships between senior asset managers, lawyers and fund executives. Citigroup found this out the hard way in 2009 when the Abu Dhabi Investment

Authority alleged that the bank had made 'fraudulent misrepresentations' when negotiating the terms of an investment in the group, something Citigroup strenuously denied. The Abu Dhabi Investment Authority sued for US\$4bn in damages. For the *Financial Times* the cause of the falling out was, however, less to do with financial technicalities and more to do with the "The bank's failure to coddle some of its most important stakeholders...investors may feel the bank has become too distracted to give them the pampering they believe they deserve" (Beer, 2009). Citigroup's embroilment in the financial crisis and the resultant need to rescue the bank and keep politicians in the USA onside had, according to the *Financial Times*, led to a breakdown in the close and trusting relationships needed to keep SWF investors happy.

As a result of the value SWFs place on close relationships between senior fund executives and professional advisors, since 2000 financial service firms have been racing to develop in situ presences in financial centres associated with major SWFs. For example, three of the five largest asset management firms responsible for managing in excess of US\$5000bn of third party assets have offices in Dubai, with over 50 private equity companies also having offices in the city including Carlyle Group and Cerberus. Related professional services such as law have also been quick to establish a presence close to the executives managing SWFs. For example, the American law firm Latham & Watkins LLP has advised the Qatar Investment Authority since 2005 (the fund was only established in 2003) and setup an office in Doha in 2008 as well as offices in Abu Dhabi and Dubai. The rationale according to the firm's global finance chair: "clients of ours were telling us 'you need to be here'" (quoted in Byrne, 2008). Similarly the US firm Shearman & Sterling LLP has an office in Abu Dhabi purely because of its relationship with the Abu Dhabi Investment Authority. As one partner from the firm noted, "Making sure we maintain a good relationship with these clients is very important to the firm" (quoted in Berris, 2008). Identical

explanations exist for Baker & McKenzie's growing presence in Almaty (the firm helped setup and works for the Kazakhstan National Fund).

This rush to be co-present with the executives running SWFs inevitably means that financial centres such as Dubai and Doha will become strategically more important in the activities of financial institutions, professional services but also companies seeking capital injections, thus making the centres more powerful nodes in global financial geographies. The centre of gravity in the financial system is slowly shift eastwards (on which see Grether and Mathys, 2010) and incumbent centres will have to learn to coexist with others that have new roles in the international financial system. However, there is also another story that runs in parallel to such developments that suggests such a rebalancing of power might not lead to as dramatic an erosion of the power base of incumbent financial centres as the most extremely hyperbolic tales might suggest.

### **Internationalisation, relationality and complementarity**

SWFs are increasingly internationalising their investment activities. Although exact figures are hard to attain because of the secretive nature of SWFs, it is widely held that the first funds – such as the Kuwait Investment Authority which was established in 1953 – initially relied on domestic investments and until the last years of the 20<sup>th</sup> century engaged in limited international investment (see Bortolotti et al., 2009). However since the turn of the new millennium existing funds have increasing internationalised their investment strategies and the tens of new funds to emerge, such as the Qatar Investment Authority, have in many cases been 'born global', the Qatari fund for example being the polar opposite

of the Saudi Arabian fund discussed above, having 100 percent of investments overseas. Consequently by 2008 almost 80 percent of SWFs' investments were overseas with domestic investments becoming less significant, although still worth US\$760 billion in 2009 (Bortolotti et al., 2009).

A wide range of high profile investments at the height of the financial crisis bear testament to the growing importance of the internationalisation of SWFs. These include:

- The purchase of a 90 percent share of New York's iconic Chrysler Building, a 100 percent stake of Manchester City Football Club, and a US\$7.5bn share of Citigroup at the height of the financial crisis by the Abu Dhabi Investment Authority.
- The China Investment Corporation's pumping of over US\$3bn into a JC Flowers private equity fund that was designed to be used to rescue ailing banks, principally in the USA, and the purchase by the same fund of a ten percent share in Morgan Stanley.
- Investments of US\$2bn each by the Korea Investment Corporation and the Kuwait Investment Authority in Merrill Lynch
- Investment of US\$4bn in Standard Chartered PLC by Temasek, the Singaporean fund.

However, these examples provide the first hint of why the activities of SWFs might not simply lead to a zero sum game whereby the rebalancing of power in the financial system leads to the erosion of the powerfulness of incumbent centres such as London and New York. SWFs played an important role in enabling the survival of the financial services system in many incumbent centres during the financial crisis, both because of the bailouts provided to failing banks and because of the transactions SWF's enabled at a time when reduced liquidity meant many banks and related professional services such as law were imploding due to a lack of merger and acquisition and structured finance work. For example, Aizenman and Glick (2009) report that 75 percent of all investments made between November 2007 and

January 2008 at the height of the financial crisis were by SWFs. As such they helped reduce the damage caused by the financial crisis in incumbent centres, thus helping these centres to retain their powerfulness in the international financial system. And it is not just the credit crisis and the way SWFs helped save incumbent centres that suggests the internationalisation of SWFs might actually help maintain the powerfulness of incumbent centres.

Over the coming decade SWFs will continue to channel their investments through centres such as London and New York. Having a diverse portfolio of investments is vital if SWFs are to guarantee the long-term stability of their investments and the access incumbent centres provide to a diverse array of investment opportunities will prove indispensable. Affirming this idea, the Kuwait Investment Office, Brunei Investment Authority, Abu Dhabi Investment Authority, Temasek of Singapore and the China Investment Corporation all have or are in the process of setting up offices in London to act as conduits for their investments. Meanwhile data on the geography of SWFs' international investment activities reveals that at present the USA receives 22 percent of all investments and the UK 13 percent (see Bortolotti et al., 2009) with 45 percent of investments being in US dollars and 40 percent in Euros and the British Pound, half of which gets channelled through London (see Diwan, 2009; IFSL, 2010). No wonder the UK government is keen to maintain London as a destination for SWFs' investments, the City minister Kitty Ussher stating that "Using London as a base allows funds to keep close the world's financial markets. We welcome funds using London in that way" (quoted in Parker and Arnold, 2007).

Moreover the increasing use of 'western', principally American and British, asset managers, private equity funds and associated professional services such as law by SWFs also brings benefits for incumbent centres such as London and New York. Whilst, for the reasons outlined above, these firms



provide advice to SWFs in situ, the way such firms operate more often than not results in experts from incumbent centres being involved in serving SWF clients. Two examples illustrate this process. First, the investment decision-making process when involving international investments outside of a SWF's home-country requires investment research but also risk related judgements by asset management professionals. As a result the rationale for using asset managers such as BlackRock – now allied with Barclays Global Investors – is to access the world-renowned expertise possessed by managers in the home-countries of the firms. This generates important financial services work in incumbent centres, despite the fact that it may be, for example, the Abu Dhabi or Beijing office that is delivering the advice to clients and billing for the work.

A second example relates to the structuring of investments by SWFs. The almost universal use of either English or New York State law means that not only do English and US firms regularly get called on by SWFs but a significant amount of the work completed by the Abu Dhabi, Almaty, Doha and Dubai offices of law firms such as Latham & Watkins LLP, Shearman and Sterling LLP, Allen & Overy LLP and Clifford Chance LLP involves lawyers in London or New York. Again the expertise of professionals in incumbent centres is central to the successful execution of transactions and generates demand for financial services in centres such as London and New York. In the case of some English and American law firms such as DLA Piper and Simmons & Simmons this has involved advising on SWFs' investments in Africa by using a combination of in situ presence in the SWF's home country, in Africa but also in London and/or New York because of the role of English and New York State law in transactions.

Incumbent centres such as London and New York are benefitting, then, from the relational nature of the international financial system. The best way to further explain this is by comparing the likely impacts of

developments associated with SWFs and financial centres in the Middle East and Asia with debates at the turn of the new millennium when it was postulated that, in the European context, London's powerfulness was under threat from Frankfurt and Paris because of the centrality of the two cities in the new Euro currency zone. Studies of London's position in European finance (see Beaverstock et al., 2006; Clark, 2002; Faulconbridge, 2004) revealed that, in reality, London's powerfulness was not under threat for two reasons. First, the relational nature of finance meant that the three cities were not competing but were cooperating. Each city was fulfilling a different role in the European financial system with only a few areas of overlap that were likely to lead to the migration of financial transactions and financial service work and firms from one city to another. Second and related it was shown that the cities were therefore complementary, together forming a European financial system that grounded particular types of transaction in each city and involved flows of capital between centres.

In the case of the recent growth of financial centres such as Dubai and Doha, a relational and complementarities approach suggests that incumbent and new centres actually coexist and complement one-another. The home-country centres of SWFs fulfil a particular role in relation to the domestic investments of funds and allow the channelling of profits, for example through project finance initiatives, whilst centres such as London and New York offer SWFs investment opportunities not available at home. As such, whilst the new centres will grow, the east to west flows of capital generated by SWFs will also help sustain and possibly even grow financial services markets in incumbent centres. In the future, then, the coexistence and complementarity of financial centres stretching from the USA in the west through Europe, the Middle East, China and further eastwards to Korea is likely to be a defining feature of a more relational and more international financial system. For Helleiner (2009) this is indicative of how SWFs are actually the allies of the west and its financial services system and centres

whilst for Pistor (2009) this is a sign of the role of 'global network finance' in which reciprocal flows of capital between more numerous sources and sinks than existed in the 20<sup>th</sup> century defines international markets and the geographies of power in the financial services system in the 21<sup>st</sup> century.

## **Conclusions**

In this commentary I have suggested that SWFs will indeed play an important role in the rebalancing of the geographies of financial services power. Over the next decade centres such as Doha, Dubai and Riyadh will undoubtedly become more and more important as sites of financial services work as a multi-polar financial system develops. But these centres will coexist alongside and complementing incumbent centres such as London and New York. As a result there will be qualitative changes in the role of incumbent centres such as London and New York as part of a transition to a multi-polar international financial system. But this does not mean centres such as London and New York will be disempowered and wither. Rather incumbent centres such as London and New York may well remain the most powerful financial centres because of their now well established and unique role in terms of the provision of a broad array of sophisticated financial services.

The geographies of power relations in the international financial system are, then, not a zero sum game. The nature of the 21<sup>st</sup> century financial services system is indeed likely to generate an even more complicated picture of global flow and interconnectivity that means a multi-polar world of finance comprised of an increasing number of powerful centres will exist. But these centres will operate synergistically to produce a new spatial ecology of international finance that generates new trading opportunities rather than simply leading to the relocation of existing trading. SWFs are undoubtedly

playing a key role in such developments. But, just as Kirshner (2009) suggests in relation to the political motivations of SWFs, the role of funds and new financial centres should not be feared by cautiously embraced as an integral part of a 21<sup>st</sup> century international financial system.

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