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WHAT CAN TURKEY'S SOVEREIGN WEALTH FUND DO WITH THIS PORTFOLIO?

The Turkish Sovereign Wealth Fund (TWF) has recently been in the subject of public discussion since its establishment in August 2016. The National Lottery, games of chance and horse racing were placed in the Fund since. On February 5th, the subject came up again when some public lands as well as public securities listed in the following table were added to the fund. The public shares in Turkish Airlines and Halk Bank, previously under the Privatization Administration, are the most notable additions.

[1] http://www.tepav.org.tr/en/ekibimiz/s/1016/Emin+Dedeoglu+

Company name	State Share %	Paid in Capital (TL)	Free Float (%)
THY	49,12	1,38 billion	50,18
Halkbank	51,11	1,25 billion	48,77
Ziraat Bankası	100	5 billion	
Borsa İstanbul	73,6	423,2 mio	
PTT	100	981,5 mio	
BOTAŞ	100	4,15 billion	
ETİ Maden	100	600 billion	
TPAO	100	3 billion	
Türksat	100	1,47 mio	
Türk Telekom	6,7	3,5 billion	13,31
Çaykur	100	1,49 billion	

In addition to these assets, TRY 3 billion in cash from the Defense Industry Fund was transferred to the TWF to be paid back in 3 months.

With such recent transfers, the total amount of assets in the TWF has grown significantly, spurring another round of discussions since the launch of the TWF. Many critics assert that the Fund is not transparent and exempt from the audit by the Court of Accounts. Besides, some state that, unlike the wealth fund practices in much of the world, the TWF is mainly established to provide funding for major infrastructure investments. Turkey after all, does not have abundant natural resources and balance of payments or budget surpluses. Critics, rightly underline that if the objective of the TWF is to finance the infrastructure investments, for all practical purposes, it will be no different than the past, “Public Participation Fund” implementation and so it will compromise the principle of "Unity of Treasury". As it is known, established as an off-budget fund, the Public Participation Fund financed highways and bridges, mainly by issuing Revenue Sharing Certificates (RSC’s), against the future revenues to be obtained from such investments. However, the fund practically served to circumvent fiscal discipline, issued high amounts of RSC’s, which was deeply discounted in the secondary market and eventually ended up in the Treasury’s books. Later the Fund was abolished after being transferred to the Treasury, and the outstanding RSC’s have been redeemed using tax money[2].

Moreover, it remains uncertain, for now, how these assets that are transferred are to create financial resources. As it is known, the value of financial instruments linked to specific assets is also linked to the potential returns from those assets. Value estimation is not much of a problem for the intangible assets that are transferred, like real estates or games of chance, which are easy to compare, calculate and evaluate. However there is uncertainty as to how exactly large companies’ and State Owned Enterprises’ shares are used to create funding. Perhaps it will be possible to better understand the logic of such transfers if the 3-year strategic investment plan, which is supposed to be prepared by the Board of Directors and approved by the Council of Ministers as per the article 3/2 of the Law no. 6741 launching the TWF, becomes public.

[2] Emin Dedeoğlu's evaluation note in this regard is available at (http://www.tepav.org.tr/upload/files/1473014698-4.Kamu_Mali_Yonetiminde_Neler_Oluyor_Varlik_Fonu_Ve_Tamamlayici_Odenek.pdf), it includes more detailed information about wealth funds.

Nevertheless, considering the nature of the assets transferred to the fund it is possible to speculate how to create resources from such assets. The purpose of this note is to try to do that.

Let’s focus on the company shares. First of all, I want to clarify one issue; as you already know, pursuant to the Article 4 of the Court of Accounts Law (Law no. 6085), the Court of Accounts audits "...joint-stock companies with direct or indirect public shares in their capital established under the special laws.." and "the companies along with their subsidiaries and associates which have less than 50% of the direct or indirect public share and are subject to independent audit as per the respective regulations are audited based on the independent audit reports issued by the respective regulations and to be submitted to the Court of Accounts”. Therefore, TC Ziraat Bank, Botaş, Halk Bank or TPAO which are 100% public companies are not exempt from the Court of Accounts audit once they are transferred to the TWF. The TWF Company and funds established by it, is exempted from the Court of Accounts audit. In this regard, you may check the paragraph 5 of the article 8 regulating the exemptions in the law no. 6741: “(5) The Court of Accounts Law dated 3/12/2010 and numbered 6085. (...) does not apply to the Turkey Sovereign Wealth Fund and the Company and its sub-funds and other companies established by the Company.” This practically means that unless the TWF establishes a brand new company, all the companies in which the TWF is a majority shareholder, have to be subject to the Court of Account’s audit, no matter whether they are transferred or later participated by the Fund in the stock market.

Is it possible for the TWF to raise financing by means of selling/privatizing the shares of company transferred? I don’t think so. Even if it is stated in the article 2/3a of the incorporation law (Law no. 6741) that "It (TWF) buys and sells (...) the domestic and foreign companies' shares (...) in the national and international primary and secondary markets", it is the Privatization Agency, according to the Law no: 4046, which has the primary function and authority to privatize. Therefore, although it seems technically possible for shares to be sold by the TWF, it will always be legally ambiguous. Since the resources of the Privatization Fund can be readily transferred to the TWF as per the founding law no: 6741, why should an activity deemed to be privatization, be carried out by the Wealth Fund? What purpose is this legal confusion to serve? A sceptic’s answer to this would be: “to evade the share sales/privatization operations from the Court of Account’s audit.” Although this is a possibility, its probability seems to be low. For one thing, the TWF is not fully exempt from audit; it is to be audited by independent auditors and also by 3 public auditors who are to be appointed by the Prime Minister. Moreover audit reports are to be presented to and discussed at the Planning and Budgeting Committee of the Grand National Assembly, at the end of each year. *Most importantly, the investors may consider legal ambiguity and associated contestability as a source of additional uncertainty. They may abstain from participating in privatization deals or at least adjust their prices to reflect this risk.*

How will these assets then be used to raise financing? If the companies in question are already very profitable or expected to be in the future, then the income stream of a portfolio established, comprising their share certificates, can be sold to investors. For instance, let's assume that TPAO has found a new oil field or ETİ has discovered a new mine site. Then, a fund to be comprised of share certificates of such companies can well be demanded by the investors. What is confusing is that the companies transferred to the TWF do not look alike at all. Among them, there are State Owned Enterprises or fully owned public companies which are not listed in the Stock Exchange. Their shares are not traded, and thus these companies do not have market prices. They are not subject to international audit or rating. Therefore, a portfolio based on such shares won’t have a market price either. Of the companies that are already listed in the stock exchange, Turkish Airlines is reported to incur huge losses due to terror-related cancellations or low demand. So it does not seem to be very easy to create synthetic securities based on such company shares before opening them to the public and listing them in the stock exchange. For that, there is privatization agency, as mentioned before. Likewise, there is further vagueness related with the rationale of transferring 6% share of Türk Telekom to the Fund portfolio, which has had immense loss last year appearing on its balance sheet.

Well, is it possible to transfer and securitize individual assets or income streams of these companies? It is technically and legally possible. It is stated in the article 4 of the law no. 6741 that surplus revenues, resources or assets of public organizations and institutions can be transferred to TWF by the Council of Minister's decision. But for that, the whole company doesn't have to be transferred, just the "surplus" asset, revenue stream etc. would suffice.

The more probable option for the TWF is to borrow with the possibility provided by the provision: "While financing, the Turkish Sovereign Wealth Fund may establish collateral, lien, surety and encumbrance on its portfolio." as stated in the paragraph 3 of the article 4 of the Law no. 6741. In this case, the portfolio is required to be evaluated and rated by international valuation companies. However, it is doubtful that this is a good idea. In the end, it boils down to off-budget borrowing by collateralizing some revenue-generating public assets, by evading the budget discipline and public scrutiny, for the purpose of transferring these funds to some off-budget investments.

So can the cost of such funds be lower than the one borrowed by the Treasury? Theoretically, if the debtor of an income stream to be securitized is a company in another country with better credit rating that the creditor company, it may be possible. But what could the proportion of such assets actually be, say, among the credit portfolio of Ziraat Bank or Halk Bank? Not much, if any.

So, why do we think that it is not a good idea to borrow collateralizing these assets through the TWF? Mainly for two reasons; the first is that although this is a proper borrowing, it is not likely to be accounted as "public debt" and not included in the debt stock disclosed by the Treasury[3]. Having an asset portfolio backing such borrowing does not alter its nature of being a "debt." When the Treasury borrows, its debt is implicitly backed by all the public tangible and intangible assets. (Plus authority to tax or monetize if it is TL denominated.) Therefore, all over the word, it is less costly for the governments to borrow through the conventional borrowing channels. Secondly, public assets (like debts) belong to the whole of the nation and mostly to the next generations. Therefore, under normal conditions, the dispositions regarding these assets (purchase, sales, borrowing etc.) must be performed under the supervision and with the approval of the parliaments representing the nation. This is what the budgeting process is all about. Therefore, "budget right" is a democratic right. Therefore, borrowed funds not included in "general government" debt, although they are properly so, and any off-budget transactions that are not subject to the scrutiny of the parliament, will always raise doubts. Doubts accumulate and weakens the credibility of overall fiscal policy.

In addition to all of the above, the purpose of the TRY 3 billion transferred from the Defense Industry Fund temporarily (for 3 months) to the TWF is unclear. One of the likely uses could be providing emergency funding to some large infrastructure investments, which may have some financing difficulties. How is this possible? Again, as per the Law no. 6741: "It (the

[3] In accordance with the IMF Government Finance Statistics (2014) guide, regulating the international public accounting principles, the wealth funds managed by a company having a legal entity are not included in scope of the "general government", therefore the debts of such funds are not classified as "public debt" according to the EU definition.
http://www.imf.org/external/Pubs/FT/GFS/Manual/2014/gfsfinal.pdf page 37.

TWF) performs any kinds of commercial and financial activities in national and international primary and secondary markets. **The company (TWF) may participate in national investments as well as investments made by other governments and/or foreign companies in international arena."** Thus, for e.g. TWF can directly participate in "Kanal İstanbul" or any other investment for that matter.

In the past, the Treasury similarly borrowed from Employee's Saving Incentive Account (ESIA) by placing treasury bills. Today too, public debt securities are sold to the Unemployment Fund. The problem is not the borrowing itself, but rather doing it in an unconventional and untransparent way and calling it "non-debt creating financing," thus putting a lot of question marks in the minds of observers, undermining the hard-won credibility of fiscal policy and the principle of the unity of treasury. Sometimes the cure is worse than the illness.

The ESIA adventure started in mid-1980s. The Public Participation Fund, whose motto was "financing without creating debt" was also established at about the same time. Their value and contribution to the public sector is debatable, but it took almost 20 years to liquidate them fully, and this was done mainly by tax proceeds.