DOI: 10.17512/CUT/9788371939563/27

WALK THE TALK? - THE INVOLVEMENT OF SOVEREIGN WEALTH FUNDS IN REPUTATIONAL RISK SCANDAL CASES

Marty-Jörn Klein, Martin Kaloudis
Mendel University in Brno

Theodoros Christodoulou
Aristotle University of Thessaloniki, School of Economics

Abstract: This paper presents a comprehensive analysis of the involvement of major 24 Sovereign Wealth Funds (SWFs) in reputational risk scandal cases, utilizing data from Refinitiv spanning the period 2007-2020. These SWFs collectively account for 87% of global SWFs' assets under management and 94% of their public equity holdings. The study investigates whether SWFs were invested in the public equity holdings of companies involved in scandal cases, both at the time of the scandal's appearance and during a two-year period before and after the event. The findings reveal that commodity-based Reserve Investment Funds from developed countries with a liberal investment style, particularly those characterized as balanced growth investors, exhibit over-proportional involvement in reputational risk cases. This trend also holds true for SWFs with the highest levels of transparency in environmental, social, and governance (ESG) and sustainable development goals (SDG) matters, which typically rely on self-reported ESG information provided by invested companies. The findings raise questions about the alignment of some evaluated SWFs' investment behaviours with their stated commitment to "walk the talk" on ESG and SDG matters.

Key words: Sovereign Wealth Funds, ESG, reputational risk, exogeneous shock, special events, scandal cases, Corporate Social Responsibility.

Introduction

Scandal cases are not uncommon in the financial industry, with Credit Suisse being just one recent example. In addition to environmental damage, events such as the Volkswagen diesel gate affair and the BP Deepwater Horizon disaster have resulted in significant losses for investors in terms of public equity stakes. However, it is not just financial losses that result from such scandals - the reputational damage to the companies involved and the industries they operate in can also be severe (Malik, Chowdhury, Alam 2023, p. 2).

The involvement of Sovereign Wealth Funds (SWFs) in these scandal cases has attracted significant attention in recent years (Liang, Renneboog 2020, p. 386). As large, government-owned investment funds with significant assets under management, SWFs are expected to act as responsible, long-term investors with a focus on ESG factors (Cuervo-Cazurra, Grosman, Megginson 2021, p. 80). However, their involvement in reputational risk cases has raised questions about their alignment with ESG goals and their impact on long-term sustainability.

Against this backdrop, this paper presents an analysis of the involvement of major 24 SWFs in reputational risk scandal cases. These SWFs collectively account for a significant portion of global SWFs' assets under management and public equity holdings (Aggarwal, Goodell 2018, p. 85; Farag, Neupane, Marshall et al. 2022, p. 4). The study aims to investigate whether SWFs were invested in the public equity holdings of companies involved in scandal cases, both at the time of the scandal's appearance and during a two-year period before and after the event (Martínek 2021, p. 5). The findings provide valuable insights into the investment behaviour of SWFs in relation to reputational risk scandals and contribute to the ongoing debate around responsible investment and sustainable finance (Nobanee, Alhajjar, Abushairah et al. 2021, p. 3).

Background, History, Review-of-Literature, and Methodology of the research

Private investors, whether through direct equity investments or investments in Exchange Traded Funds (ETFs) and mutual funds, may lack the expertise, time, and financial resources to identify potential scandal cases before they occur. Institutional investors, on the other hand, are expected to have the intellectual resources and capacity to investigate such matters in advance. SWFs are considered one of the most influential types of institutional investors in the global financial system, alongside pension funds and insurance companies (Bortolotti, Fotak, Megginson 2015, p. 3012). Their massive assets under management and long-term investment horizons give them significant power to shape the financial markets, and their investment behaviour has an impact on the overall stability and sustainability of the system (Dyck, Lins, Roth et al. 2019, p. 701).

While SWFs may have different financial backgrounds, including commodity-based investments in oil and gas, their primary goal is to preserve state-owned capital over the long term (Gangi, Meles, Mustilli et al. 2019, p. 440). As such, they are expected to act as responsible, long-term investors with a focus on ESG factors. However, their involvement in scandal cases has raised questions about their alignment with ESG goals and their impact on long-term sustainability (Wurster, Schlosser 2021, p. 16).

Investigating the involvement of SWFs in reputational risk scandals is important for several reasons. First, as significant investors in public equity holdings, SWFs have the potential to exert significant influence on the companies they invest in (Aizenman, Glick 2009, p. 372; Grasso 2017). Additionally, as large and influential investors in the global financial system, SWFs have a unique responsibility to consider ESG factors in their investment decisions. This is not only important for promoting long-term sustainability and stability in the financial system, but also for ensuring that SWFs align with the values and priorities of their respective countries and citizens. Finally, as major players in the global financial system, the investment behaviour of SWFs can have significant implications for the overall sustainability and stability of the financial system (Megginson, Fotak 2015, p. 782; Bassan 2015).

The global financial industry has been rocked by numerous scandal cases over the years, with more than 20 high-profile cases having emerged in recent times. These cases have resulted in significant financial losses for investors, as well as irreparable reputational damage for the companies involved and their respective industries (Liang, Renneboog 2020, p. 411; Dai, Song, You et al. 2022, p. 2).

Examples of such scandal cases include the Volkswagen diesel gate affair, which resulted in the company paying billions in fines and compensation for manipulating emissions data, and the BP Deepwater Horizon oil disaster, which caused the largest marine oil spill in history and cost the company billions in clean-up efforts and settlements.

The widespread impact of these scandal cases on the financial industry highlights the importance of responsible investment practices and the need for investors to carefully consider potential reputational risks associated with their investment decisions.

The reputation of companies and industries can be severely impacted by scandals, resulting in significant financial losses and long-lasting effects. The objective of this research is to investigate the involvement of SWFs in public equity holdings of companies that have been involved in reputational risk scandals. The study covers a time frame of 13 years, from 2007 to 2020, and aims to provide insights into the investment behaviour of SWFs and their potential impact on long-term sustainability, particularly in relation to ESG factors. Using data from Refinitiv, the study examines the involvement of 24 major SWFs by AuM and available public equity holding data in these scandal cases. These SWFs collectively manage a significant portion of global assets under management and public equity holdings. By analysing their investment behaviour during the period leading up to, during, and after the scandal events, the study aims to provide valuable insights into the role of SWFs in promoting responsible and sustainable investment practices.

The findings of this study will provide valuable insights into the investment practices of SWFs and their potential impact on long-term sustainability, particularly regarding ESG factors. As responsible, long-term investors, SWFs are expected to promote sustainable investment practices and mitigate potential risks associated with scandal events.

By understanding the investment behaviour of SWFs in relation to reputational risk scandals, stakeholders can work towards improving the overall transparency and accountability of the global financial system. This study is significant to investors, regulators, and policymakers alike, as it highlights the need for responsible investment practices and promotes the long-term sustainability of the financial system.

An increasing number of studies (Liang and Renneboog, 2020; Farag et al., 2022) have examined the extent to which SWFs integrate ESG considerations into their investment decision-making processes. These studies have typically analysed the relationship between the ownership stakes of underlying companies and their ESG scores. For example, Liang and Renneboog (2020) found that SWFs take both historical ESG performance and recent improvements in ESG scores into account when acquiring ownership stakes in publicly traded companies. However, ESG scores have several limitations, including reliance on self-reported information, which may result in opaque content (Bautista-Puig et al., 2021; Johan et al., 2013; Jory et al., 2010).

Table 1. Definition and description of variables

Variable	Type	Scale Level	Binary	Variable's Categories	Additional information
INVESTMENTi	Dependant	Nominal	Yes	0="No", 1="Yes"	Investment in ESG scandal case
ESGi (X1i)	Independent	Nominal	Yes	0="No", 1="Yes"	ESG disclosure of the SWF
SDGi (X2i)	Independent	Nominal	Yes	0="No", 1="Yes"	SDG disclosure of the SWF
Origin of assets (X3i)	Independent	Nominal	Yes	0="Commodity", 1="Non-commodity"	
Purpose of SWF (X4i)	Independent	Nominal		1="Savings Fund", 2="Pension Reserve Fund", 3="Development Fund", 4="Stabilization Fund", 5="Reserve Investment Fund", 6="Other"	
Investment Style (X5i)	Independent	Nominal		0="No data", 1="Liability Driven Investor", 2=" Balanced Growth Investor", 3="Strategic Return Maximizer"	
Country's Economic Development (X6i)	Independent	Nominal		0="No data", 1="Frontier", 2="Emerging", 3="Developed"	

Source: Own study

Involvement of SWFs in defined public equity scandal cases is defined as investment and disinvestment in at least 1 out of 20 investments during 2007-2020.

Hypothesis 1 (H1): SWFs do avoid investments in public equity scandal cases by taking into account both historical ESG performance and recent improvements in ESG scores when acquiring ownership stakes in publicly traded companies.
To test and then possibly find support for the hypothesis, the following alternative null hypothesis has been formulated:
Hypothesis 0 (H0): SWFs do not avoid investments in public equity scandal cases by considering both historical ESG performance and recent improvements in ESG scores when acquiring ownership stakes in publicly traded companies.
The Logit Regression Models for the dependent variables are as follows:
INVESTMENTi = Logit (b0 + b1*X1i + b2*X2i + b3*X3i + b4*X4i + b5*X5i + b6*X6i) + ui

The findings suggest that the hypothesis H0 can be confirmed at a confidence level of 95%. SWFs do not avoid investments in public equity scandal cases by considering both historical ESG performance and recent improvements in ESG scores when acquiring ownership stakes in publicly traded companies. Hence, we must reject hypothesis H1. The findings reveal that commodity-based (Figure 1) Reserve Investment Funds (Figure 2) from developed countries (Figure 3) with a liberal investment style, particularly those characterized as balanced growth investors (Figure 4), exhibit over-proportional involvement in reputational risk cases. This trend also holds true for SWFs with the highest levels of transparency in ESG (Figure 5) and sustainable development goals (SDG) (Figure 6) matters, which typically rely on self-reported ESG information provided by invested companies (Klein 2021, p. 45).

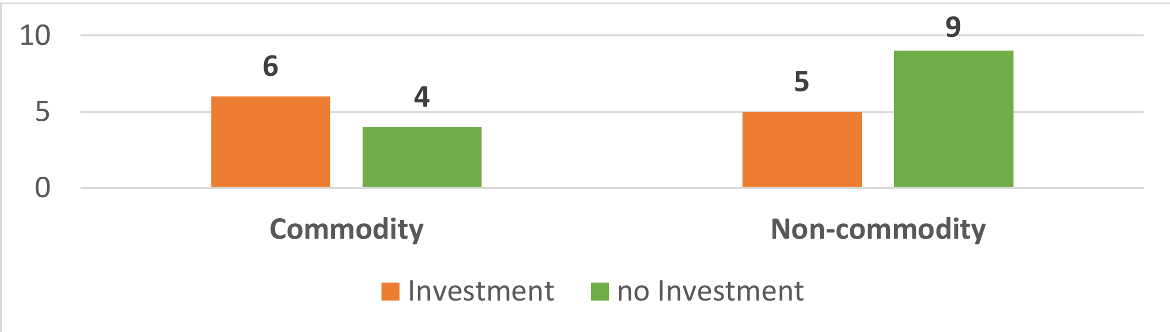

Figure 1. Bar chart showing involvement of top 24 SWFs by AuM in public equity scandal cases – by origin of assets

Source: Own study

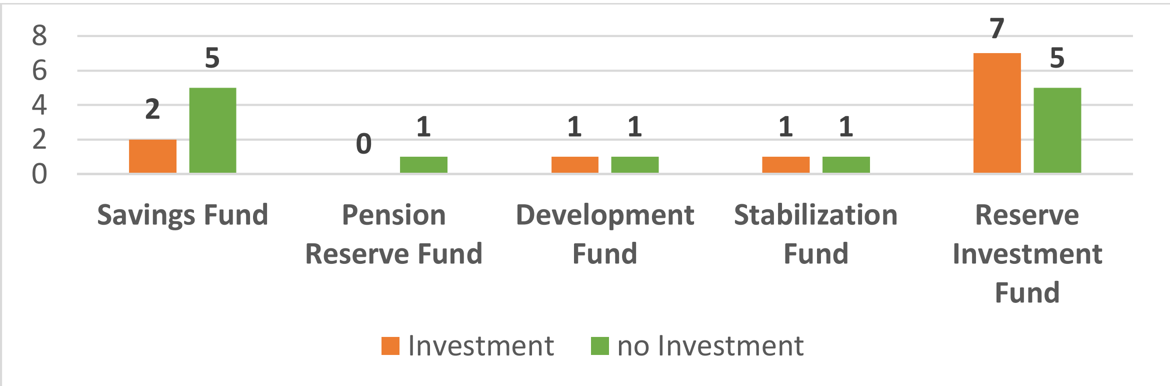

Figure 2. Bar chart showing involvement of top 24 SWFs by AuM in public equity scandal cases – by purpose of SWF

Source: Own study

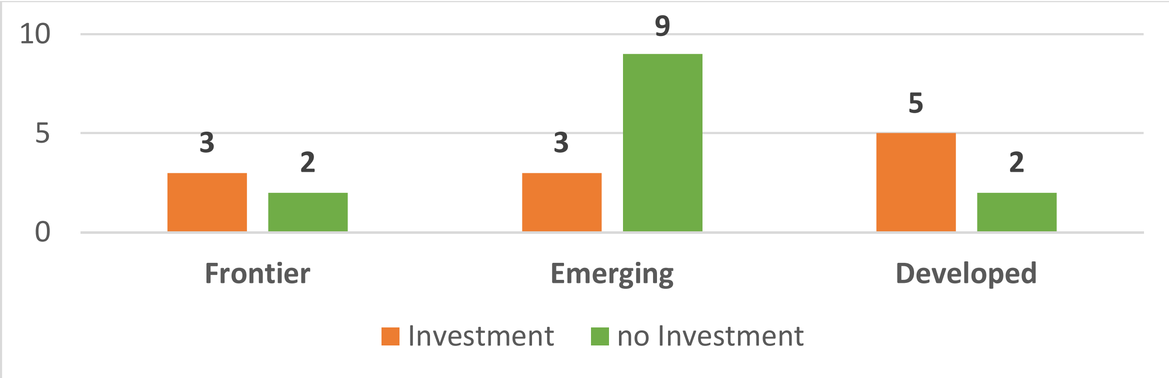

Figure 3. Bar chart showing involvement of top 24 SWFs by AuM in public equity scandal cases – by country`s economic development

Source: Own study

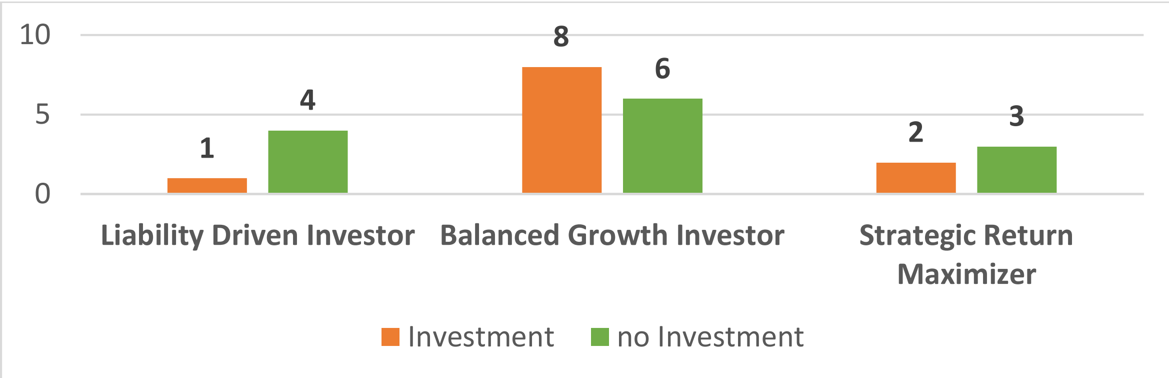

Figure 4. Bar chart showing involvement of top 24 SWFs by AuM in public equity scandal cases – by investment style

Source: Own study

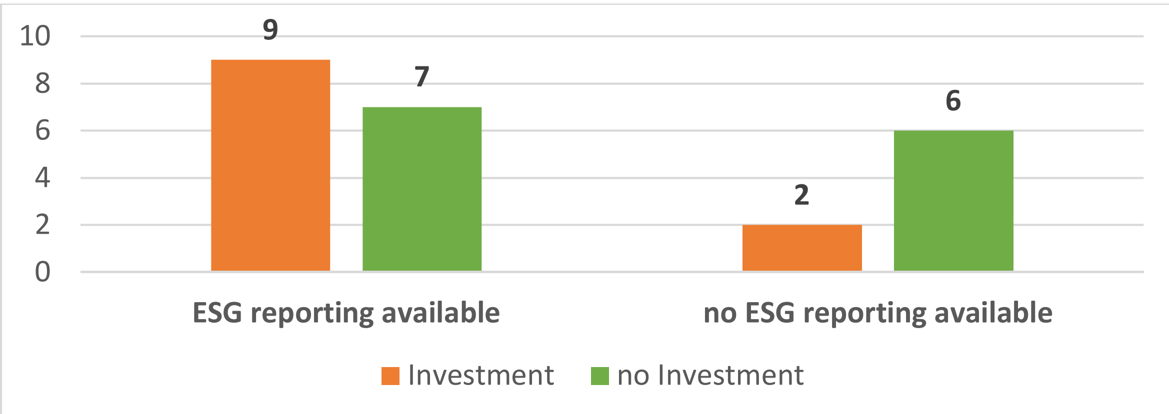

Figure 5. Bar chart showing involvement of top 24 SWFs by AuM in public equity scandal cases – by transparency on ESG goals

Source: Own study

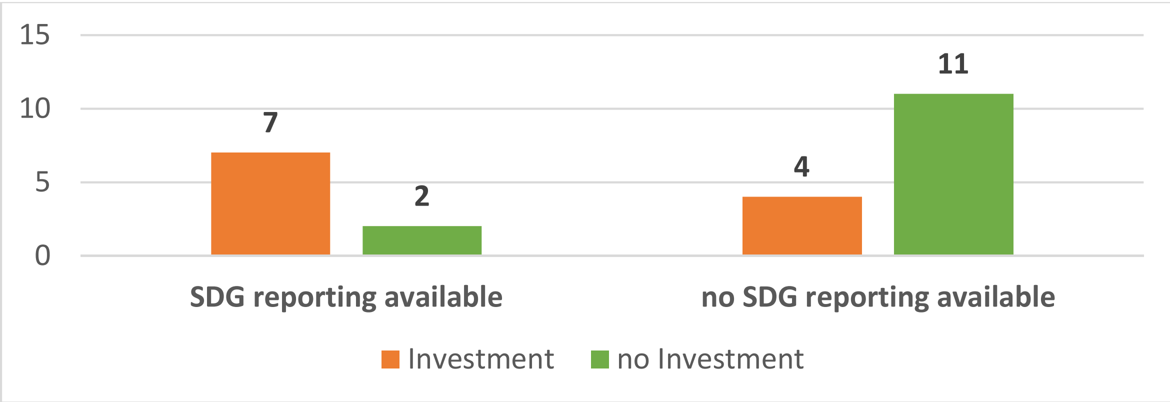

Figure 6. Bar chart showing involvement of top 24 SWFs by AuM in public equity scandal cases – by transparency on SDG goals

Source: Own study

Discussion

The findings of this research shed light on the potential misalignment between the investment behaviour of certain SWFs and their stated commitment to ESG and SDG matters. It suggests that certain SWFs, such as the Government Pension Fund Global (Norway), the Korea Investment Corporation (Korea), the Alberta Investment Management Corporation (Canada), and the Texas Permanent School Fund (United States of America), have a higher involvement in global scandal case investments.

It supports the results of studies performed by e.g., Liang and Renneboog (2020) and Farag et al. (2022). They have provided support for the integration of ESG considerations by SWFs in their investment decision-making processes. These studies typically explore the correlation between SWFs' ownership stakes in companies and the companies' ESG scores. Liang and Renneboog (2020) specifically found that SWFs consider both the historical ESG performance of companies and their recent improvements in ESG scores when acquiring ownership stakes in publicly traded companies.

Despite the positive results from these studies, it is important to acknowledge certain limitations associated with ESG scores. Notably, these scores rely on self-reported information, which can lead to potential issues related to transparency and accuracy. Scholars such as Bautista-Puig et al. (2021), Johan et al. (2013), and Jory et al. (2010) have pointed out the concerns related to opaque content stemming from the use of self-reported data in calculating ESG scores.

While it may be due to their larger portfolio size and diversified equity holdings, this does not guarantee protection from the impact of scandal cases. In addition, the engagement of SWFs in scandal cases has prompted significant scrutiny regarding their commitment to ESG goals and their potential impact on long-term sustainability (Wurster & Schlosser, 2021, p. 16). These scandals have cast doubt on the extent to which SWFs prioritize responsible investment practices and ethical considerations in their decision-making processes. Such incidents have led to concerns about the overall credibility and credibility of SWFs in terms of upholding ESG principles and contributing to sustainable development.

In some cases, there might be a time lag between current reporting on ESG and SDG topics and historical self-reported ESG data as basis for an investment decision. A change in ESG figures has not been considered. Furthermore, the influence of SWFs on ESG data of underlying assets has not been considered in this analysis.

It is crucial to understand whether SWFs consider only self-reported ESG and SDG data or rely on independent sources for their investment decisions. This leaves room for further research to investigate how SWFs can better align their investment behaviour with their commitment to sustainability and responsible investing. As significant investors in the global financial system, SWFs must prioritize the long-term sustainability of their investments and consider reputational risks associated with investing in companies with poor ESG practices.

Conclusion

In conclusion, the study presented a comprehensive analysis of the involvement of major SWFs in reputational risk scandal cases over a 13-year period from 2007 to 2020. The findings suggest that the financial involvement of SWFs in scandal cases is correlated with various characteristics of SWFs, as well as countries' domestic economic conditions and risk factors. The study raises questions about the alignment of some SWFs' investment behaviour with their stated commitment to ESG and SDG matters. It highlights the importance of promoting responsible investment practices and mitigating the potential negative impacts of reputational risk scandals. Further research is needed to investigate whether SWFs consider independent ESG data sources when making their investment decisions.

Therefore, we recommend further research in this area using independent data sources. These findings are of great significance to investors, regulators, and policymakers and can contribute to the stability and sustainability of the global financial system.

Literature:

1. Aggarwal, R., Goodell, J.W. (2018), Sovereign Wealth Funds Governance and National Culture, *International Business Review*, 27, 78-92, https://doi.org/10.1016/j.ibusrev.2017.05.007.
2. Aizenman, J., Glick, R. (2009), Sovereign wealth funds: Stylized facts about their determinants and governance, *International Finance*, 12(3), 351-386, https://doi.org/10.1111/j.1468-2362.2009.01249.x.
3. Bassan, F. (2015), Sovereign wealth funds: A definition and classification, In Research Handbook on Sovereign Wealth Funds and International Investment Law. Edward Elgar Publishing, https://doi.org/10.4337/97817 81955208.00011.
4. Bautista-Puig, N., Aleixo, A. M., Leal, S., Azeiteiro, U., Costas, R. (2021), Unveiling the research landscape of sustainable development goals and their inclusion in higher education institutions and research centers: major trends in 2000–2017. *Frontiers in Sustainability*, 2, 12, https://doi.org/10.3389/frsus.2021.620743.
5. Bortolotti, B., Fotak, V., Megginson, W. L. (2015), The Sovereign Wealth Fund Discount: Evidence from Public Equity Investments, *The Review of Financial Studies*, Volume 28, Issue 11, November 2015, Pages 2993-3035, https://doi.org/10.1093/rfs/hhv036.
6. Cuervo-Cazurra, A., Grosman, A., Megginson, W. L. (2021), A review of the internationalization of state-owned firms and sovereign wealth funds: Governments nonbusiness objectives and discreet power, *Journal of International Business Studies*, https://doi.org/10.1057/s41267-022-00522-w.
7. Dai, L, Song, C., You, Y., Zhang, W. (2022), Do sovereign wealth funds value ESG engagement? Evidence from target firm's CSR performance, *Finance Research Letters*, 50, 103226. https://doi.org/10.1016/j.frl.2022.103226.
8. Dyck, A., Lins, K. V., Roth, L., Wagner, H. F. (2019), Do institutional investors drive corporate social responsibility? International evidence, *Journal of financial economics*, 131(3), 693-714. https://doi.org/10.1016/j.jfineco.2018.08.013.
9. Farag, H., Neupane, B., Marshall, A. P., Koirala, S. (2022), The Impact of Sovereign Wealth Funds Investment on Firm ESG Reputation Risk, *Available at SSRN 4141487*, https://dx.doi.org/10.2139/ssrn.4141487.
10. Gangi, F., Meles, A., Mustilli, M., Graziano, D., Varrone, N. (2019), Do investment determinants and effects vary across sovereign wealth fund categories? A firm-level analysis, *Emerging Markets Review*, 38, 438-457, https://doi.org/10.1016/j.ememar.2018.12.004.
11. Grasso, G. (2017), Constitutionalism and Sovereign Wealth Funds, *Global Jurist*, 17(2), https://doi.org/10.1515/gj-2016-0018.
12. Johan, S. A., Knill, A., Mauck, N. (2013), Determinants of sovereign wealth fund investment in private equity vs public equity. *Journal of International Business Studies*, 44, 155-172, https://doi.org/10.1057/jibs.2013.1.
13. Jory, S. R., Perry, M. J., & Hemphill, T. A. (2010), The role of sovereign wealth funds in global financial intermediation. *Thunderbird International Business Review*, 52(6), 589-604, https://doi.org/10.1002/tie.20381.

14. Klein, M.-J. (2021), The value of sustainability reporting for sovereign wealth funds - an analysis of the disclosure behaviour for environmental, social. In: PEFnet 2021: Abstracts. 1st ed. Brno: Mendelova univerzita v Brně, 2021, p. 45-46, ISBN 978-80-7509-811-5.
15. Liang, H., Renneboog, L. (2020), The global sustainability footprint of sovereign wealth funds, *Oxford Review of Economic Policy*, 36(2), 380–426, https://doi.org/10.1093/oxrep/graa010.
16. Malik, I. A., Chowdhury, H., Alam, M. S. (2023), Equity market response to natural disasters: Does firm's corporate social responsibility make difference?. *Global Finance Journal*, 55, 100801, https://doi.org/10.1016/j.gfj.2022.100801.
17. Martínek, S. A. (2021), The impact of Sovereign Wealth Funds on their investees: Methodology limitations, *Research in Globalization*, 3, 100072, https://doi.org/10.1016/j.resglo.2021.100072.
18. Megginson, W. L., Fotak, V. (2015), Rise of the fiduciary state: A survey of sovereign wealth fund research, *Journal of Economic Surveys*, 29(4), 733-778, https://doi.org/10.1002/9781119158424.ch7.
19. Nobanee, H., Alhajjar, M., Abushairah, G., Al Harbi, S. (2021), Reputational Risk and Sustainability: A Bibliometric Analysis of Relevant Literature, *Risks*, 9(7), 134, https://doi.org/10.3390/risks9070134.
20. Wurster, S., Schlosser, S. J. (2021), Sovereign Wealth Funds as Sustainability Instruments? Disclosure of Sustainability Criteria in Worldwide Comparison, *Sustainability*, 13(10), 5565, https://doi.org/10.3390/su13105565.