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SWFs and Corporate Social Responsibility

Christine Bischoff and Geoff Wood

Abstract In recent years, alternative investors—private equity, hedge funds, crowdfunding, and sovereign wealth funds (SWFs)—have assumed an increasingly high profile worldwide. What sets such investors apart are their distinct agendas, their lack of commitment to specific industries or locales, and their focus on securing maximum returns and/or the furthering of a clear and distinct agenda. With this prominence has come a host of ethical and social responsibilities: these range from the responsibility to balance between the interests of different stakeholders which might be sometimes conflicting to intergenerational competition for resources. Many resource-rich states—including those in the Gulf—have their own SWFs. This chapter provides an introduction to the SWF ecosystem and highlights the range of ethical and corporate social responsibility (CSR)

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debates that emerge, both for Middle Eastern SWFs and those from further afield, identifying best practices and potential ways forward.

Keywords Middle East • Sovereign wealth funds • Gulf states • Norway's Government Pension Fund-Global

In recent years, alternative investors—private equity, hedge funds, crowdfunding, and sovereign wealth funds (SWFs)—have assumed an increasingly high profile worldwide. What sets such investors apart are their distinct agendas, their lack of commitment to specific industries or locales, and their focus on securing maximum returns and/or the furthering of a clear and distinct agenda. With this prominence has come a host of ethical and social responsibilities: these range from the responsibility to balance between the interests of different stakeholders which might be sometimes conflicting to intergenerational competition for resources. Many resource-rich states—including those in the Gulf—have their own SWFs. This chapter provides an introduction to the SWF ecosystem and highlights the range of ethical and corporate social responsibility (CSR) debates that emerge, both for Middle Eastern SWFs and those from further afield, identifying best practices and potential ways forward.

Understanding Sovereign Wealth Funds

The primary function of SWFs is a state-run intergenerational savings device; many, but not all, are funded by oil and gas revenues. There are at least 90 SWFs in the world today, although the overall number may be disputed, as a few national investment funds do not fully fit into this category; an example would be South Africa's Public Investment Corporation, which is a repository of public sector pensions but which has been used by successive national governments to pursue some of the objectives of SWFs.

SWFs originated in the Middle East and are financial bodies husbanding large foreign exchange inflows. The first SWF was the Kuwait Investment Authority; Abu Dhabi established its SWF in the 1970s and

Singapore and Norway in the 1980s. Thus, SWFs are an example of government-owned investment vehicles which have become noticeable in the global financial network. SWFs allow for state ownership which crosses international boundaries (Wood and Wright 2015): in other words, firms may be state owned but by a foreign government. This process is not one without controversy. On the one hand, it has been argued that SWF investments challenge national sovereignty. On the other hand, the disquiet of host governments has sometimes been on very ethically dubious grounds. For example, the US government has, on occasion, voiced its displeasure at the Norwegian SWF driving ethical managerial practices within the firms it targets (Wood et al. 2017).

Although some SWFs are prohibited from investing at home, others have, as part of their brief, helped in the boosting of indigenous strategic industries and/or promoting employment. This may enable governments to increase the amount of decent work and encourage firm-level practices that serve more than the simple pursuit of profit. There is no such moral obligation in respect of investments abroad. In practice, SWFs may serve not only financial, but also diplomatic, developmental, and other policy objectives; some also have an obligation to promote national values, an example being Norway's. A noteworthy minority of SWF deals involve a considerable or controlling shareholding though they tend to focus on debt and fairly small non-equity stakes (Sauvant et al. 2012; Butt et al. 2008).

The quality of SWF governance varies greatly. In some cases, such as Brunei and Equatorial Guinea, there has been a blurring of the financial interests of stakeholders and their SWF (Cumming et al. 2017a). Again, immediate concerns may eclipse the long-term purpose of intergenerational savings. This raises a key ethical concern: does a shift away from a formal intergenerational savings focus entail not only the violation of an implicit contract with the citizenry, but also whether national governments have a moral obligation to husband at least part of natural resource windfalls, given that, in resource curse terms, mineral-rich countries automatically pay a price from their endowments (Ross 2012; Cumming et al. 2017a).

At the same time, their fiduciary duties go well beyond generating returns and encompass issues of sustainability and responsibility as well

(Karametaxis 2015). It has been argued that part of the core functions of the government is an ethical responsibility to improve the conditions of its citizenry (Brown 2018). Given that it could be argued that a failure to husband at least a proportion of the wealth flowing from mineral windfalls represents a failure of responsibility, conversely, it could be argued that the decision to establish a properly administered national SWF represents in its own right an example of governmental social responsibility. Within a European context, the decision of successive UK governments not to establish an SWF to save a proportion of North Sea oil revenues represents a systematic failure of responsibility, especially when compared to Norway which did.

Again, SWFs vary greatly in terms of their relative transparency. In part, this does reflect variations in cultures and what is acceptable in different national settings (Aggarwal and Goodell 2018). It has been argued that greater transparency is more compatible with cultures that are associated with propensity to take longer term views (ibid.). At the same time, relative transparency is associated with particular patterns of investment; whilst not all opaque SWFs make "bad" investments, it is easier for ethical lapses in investment strategies to take place or persist when funds are less open to public scrutiny. A further issue is that whilst it is easy to trace and monitor significant SWF investments in publically listed firms, no matter how opaque the fund is, it is much harder to document the scale and scope of other types of SWF investments and investments in or in concert with other types of alternative investors, such as private equity or hedge funds (Cumming et al. 2017a). One of the reasons why this matters is that significant components of the latter have attracted serious ethical controversies, most notably over the relative propensity to load target firms with debt and shed employment (Engelen et al. 2017). Again, there is much variation in the performance of private equity and hedge funds (Wood and Wright 2009); indeed, it could be argued that investing in riskier funds represents an inappropriate strategy for SWFs given their function of husbanding foreign exchange windfalls (Fig. 5.1).

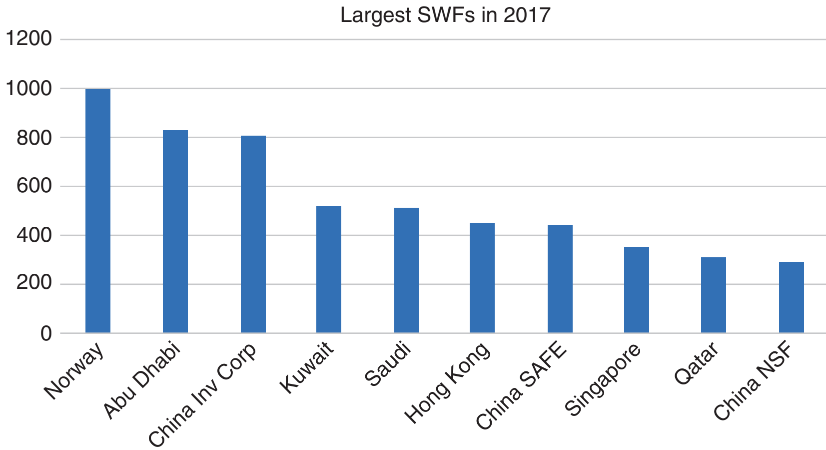

Fig. 5.1 The above graph presents the largest SWFs in the world in 2017. (Source: Statista 2017)

The Many Purposes of SWFs

Despite the primary focus on intergenerational savings, the purposes of SWFs are multifaceted. Some SWFs have extensive domestic investments in order to finance critical industries, to help preserve jobs, to sponsor monopolies, or to stimulate national development (Truman 2011) such as in the case of Dubai where SWF's resources are being used to diversify the economy away from oil and maintaining considerable and stable economic growth with oil revenues of less than 3% of gross domestic product (GDP). They can also play a fiscal stabilization role: low and volatile oil prices in recent years have led to many oil-producing nations dipping into their SWFs to plug growing and proliferating holes in their national budgets. This is not necessarily problematic, given that one of the core functions of SWFs is sustaining national prosperity, as long as the intergenerational savings function is not emasculated by this. SWFs can also play a pension reserve role. As noted above, South Africa's quasi-SWF, the Public Investment Corporation, has a primary role of husbanding state pensions (Cumming et al. 2017a, b). Although this is a generational, rather than an intergenerational, commitment, a host of ethical issues

have emerged including a lack of transparency, the blurring of fund interests and those of individual politicians, and investments in controversial asset classes.

As noted above, they can also play a national developmental role through investing in strategic industries; they may also temper privatization initiatives, through buying shares in privatized firms, shoring up, or recovering state influence over the latter.

It is worth reiterating that SWFs also represent an effort by states to locally attain the advantages of financial globalization through the institutional replication of global financial actors (Monk 2011). Given that a significant component of the latter has become shrouded in ongoing and persistent ethical controversies, and that actual track records remain uneven, this does raise some ethical concerns. Firstly, association with controversial players such as certain hedge funds may result in SWFs becoming morally compromised. Secondly, whilst a common criticism of hedge funds and private equity is that they gamble with "other people's money" (Froud et al. 2007), in the case of SWFs, this is the national exchequer.

SWFs in Emerging Economies

For developing countries, SWFs are often instituted to augment reserve saving schemes designed to shield national budgetary and balance of payments sovereignty from international financial and trade shocks such as intense commodity price fluctuations. On the one hand, being able to dip into their SWFs has certainly insulated several Gulf states from oil price volatility and relative decline; on the other hand, short-term stabilization functions may eclipse longer term viability. Kotter and Lel (2011) noticed that more transparent SWFs tended to offer capital to financially hindered firms and augment operations: in other words, they fulfil a stabilization role that goes beyond simply plugging gaps in the national fiscus. This would represent the adoption of a "business angel" role, providing firms with much-needed capital at key stages of organizational development in order to help secure their future. In the case of domestic investments, this could represent part and parcel of a broader national

developmental brief. Again, they may serve as "white knights", providing mature firms with much-needed capital during times of financial crisis, a role they performed during the 2008 economic crisis (Wirth 2018). In the case of investments abroad, this might not only make host countries more hospitable, but also represent a good in its own right; from a utilitarian perspective, as long as the outcomes are good, the underlying rationales are relatively unimportant (Singer 1993).

A sizeable number of SWFs can be categorized as "sovereign development funds", for which national or international strategic aims are of prime worth. Although this is true for some of the Gulf state SWFs, they have to date only had an uneven track record in ensuring sustainable development at home; it could be argued that a number of East Asian SWFs have been more successful in this regard, but these are countries (e.g. China, Singapore) which are much less dependent on natural resource endowments.

SWFs are disposed to widespread portfolio assets on sectoral and regional lines (Balding 2008). Recent research indicates that such investments exert a positive effect on institutions in host countries (Kant 2018). They also are critical for steadying international capital movements (Beck and Fidora 2008). The USA runs at a large balance of trade deficit, and forex inflows, inter alia, in the form of SWF investments help keep the international system afloat. As arms of national governments, SWFs assist in fostering parent country diplomatic objectives (Kimmitt 2008). Although these may, at times, be controversial, they may also serve to disseminate the positive dimensions of national values into target firms (Goergen et al. 2017). Through their acquisition of strategic assets, including firms that retain bespoke technology or agricultural land, SWFs may also help further parent country national development (Reisen 2008). This may advance food security in the case of host countries with limited capacity for developing agriculture at home.

SWFs may advance a resource nationalism agenda abroad due to the securing of foreign assets (Blackburn et al. 2008). Examples of the latter would include the procurement of agricultural land in Africa, most notably in Ethiopia and Mozambique. On the one hand, this has helped countries with poor rainfall and limited agricultural land to gain access to fertile arable land internationally. On the other hand, this has led to more

ethical disputes, such as genetically modified crops polluting indigenous seed stock, the forced dispossession of indigenous peasants, an extreme use of pesticides, agricultural chemicals leaking into the runoff, and excessive use of water (Lavers 2012; Ambaye 2015; Hall 2011; Rahmato 2011). Again, it could be argued that funds intended to safeguard future generations at home should not participate in behaviour that exposes future generations abroad. There is also a pragmatic argument: in the teeth of peasant resistance, such investments may not be sustainable. Indeed, there is wide-ranging low-key resistance in Ethiopian lowlands, ranging from arson to hit-and-run attacks (Moreda 2015). A range of similar concerns emerge in the case of mining investments abroad, particularly in repressive and conflict-ridden societies.

Transparency and Regulations

It can be seen that SWF investments may be subject to scrutiny at two levels. Firstly, this would be in terms of when they invest in listed firms, which would be subject to national corporate governance regulations. Secondly, there is regulation by home-country monetary authorities and the extent of the willingness to release key information on the latter into the public domain. In the case of the first, it is worth noting that there are differences in how SWFs assess their assets in diverse national contexts, and subsidiary investments via financial agents, which suggests that their size is essentially underestimated (Balding 2008). This may imply that the more opaque SWFs that invest in alternative investors—specifically private equity and hedge funds—may have significantly more funds than what a scrutiny of their holdings in listed firms might suggest. On the one hand, this might suggest that such funds may be more resilient than commonly assumed. On the other hand, it does open up further ethical concerns: if it is hard to trace where SWFs are investing, then it opens up further opportunities for unscrupulous actors to divert funds to suit their own interests.

With regard to the second, SWFs are regulated by national monetary authorities and are administered individually from other government assets, but they have global partialities (Blackburn et al. 2008; Makhlouf

2010). Again, how efficiently they are regulated by such authorities would reflect the quality of national government (see Baker and Boatright 2010).

Monitoring and Financial Protectionism

Many financial and political leaders have highlighted the significance of scrutinizing SWFs and some have called for their monitoring. It has been alleged that SWF investments can lead to the capture of strategic assets and the potential loss of national autonomy. Most notably, there have been periodic calls for financial protectionism—that is, greater regulation against the foreign purchase of key assets—in the USA. Indeed, there is clearly an explicit connection between the transparency of the SWF and the strength of its home-country institutions and their rule of law, as discovered by Drezner (2008).

Practically, there is a range of legal frameworks for SWFs as several countries have preferred discrete legal methods for these funds. On the positive side, the majority of SWFs publish annual reports that include information on the growth of asset allocation and investment strategy over time as well as the financial statements.

Preceding the global financial crisis and to address US apprehension and mounting demands for financial protectionism, there was an expansion of the 2008 Santiago Principles of best practices which had been drafted by the IMF and 14 of the biggest SWFs (Norton 2010). The International Forum of SWFs was founded in 2009 to create a self-regulatory method for applying, adjusting, and interpreting the principles (Norton 2010). Approximately 30 funds, encompassing the majority of SWF assets, have affiliated to the International Forum in 2016 (IFSWF 2016). Consequently, a measured attempt towards better transparency and accuracy in management with a greater emphasis on returns has materialized with briefer-term time possibilities (Balin 2010).

More transparent SWFs are exposed to extraordinary public scrutiny in their home country. This could compel fund managers to exploit returns, even if this entails more risk taking than may be necessary. More opaque SWFs may disregard human rights. For example, some of the

most notorious of the abovementioned land deals in Africa apparently incorporate blatant human rights abuses, encompassing ethnic cleansing and the murder of local human rights activists (Hall 2011; Rahmato 2011).

SWF Trajectories and Alternatives

Governments of countries that face mineral or any other foreign exchange windfalls may use this to finance an effective industrial policy, encouraging a move away from oil and gas. The idea here is that whilst the windfall will be spent, it will help enable a country to cope well with the inevitable exhaustion of mineral resources once industries have become self-sustaining. A limitation of this approach is that, whilst few countries have industrialized without an active industrial policy, easy mineral revenues may result in the challenges of securing the long-term viability of the resultant industries being neglected.

A further issue is that future generations share responsibility for the ultimate spending of mineral revenues: not only does this reduce risk but it also means that the value of the economic long term is formally recognized.

Although SWF investments abroad may court controversy, there are many examples of where they have had significantly beneficial effects (Cumming et al. 2017b). More specifically, some SWFs have successfully used their finances to help companies experiencing financial problems and thus help save many jobs that would have been lost. An example of positive SWF commitment is the billions of dollars that were granted to the troubled financial companies such as Citigroup and Merrill Lynch from China and countries like Kuwait during the global credit crisis of 2008 (ibid.). More broadly speaking, it has been argued that Gulf SWF investments have provided German industrial firms with a key source of capital, helping secure long-term approaches and, hence, ultimately shore up the German model (Haberley 2014). Even if public participation in policy setting may be low, the Abu Dhabi case would suggest that it is possible to follow broad responsible investment principles (Letourneau 2016). Again, the Saudi Public Investment Fund has, in collaboration

with the Japanese Bank, Soft, initiated a project that envisages the construction of the largest solar array in the world (DiChristopher 2018). This will provide sustainable energy security and reduce greenhouse gas emissions from the region. Some SWFs from lower income countries have adopted responsible investment policies, indicating that wealth is no barrier to responsibility (Letourneau 2016). However, as noted, the absence of a formal mandate to pursue socially responsible objectives has not precluded several funds from making investment choices partially informed by environmental or social issues (Richardson and Lee 2015). Nonetheless, piecemeal interventions may only have limited effects (ibid.).

The Case of an Ethical SWF: Norway's Government Pension Fund-Global (NGPF-G)

The NGPF-G is an SWF where the surplus wealth created by Norwegian petroleum income is retained. Despite its name, the NGPF-G is not a pension fund but could assist in funding state pensions. Managed by the Norwegian Ministry of Finance, its operational management is assigned to Norges Bank Investment Management, a division of the Norwegian Central Bank (Ainina and Mohan 2010).

The Norwegian parliament has formal control over the fund, with the Ministry of Finance being responsible for supervisory oversight and the Norges Bank for day-to-day management.

According to its governance codes, the NGPF-G may not invest at home (Alm 2012). The NGPF-G is assigned the task of ameliorating future pensions' liabilities as the Norwegian population is ageing (Dixon and Monck 2012).

In addition to this, the NGPF-G was established as an intergenerational savings mechanism to husband the wealth generated by Norway's North Sea oil windfall (Lenihan 2014; Dixon and Monck 2012). It is also intended to offer some security for Norway to counter unanticipated internal economic difficulties as well as external failures (ibid.). Thus, it was planned to serve as a stabilizing force and in fact it managed to

achieve this at the start of the 2008 economic crisis as well as during the period of a swift decline in oil and gas returns, in the wake of the 2015–2016 weakening of petroleum prices (Martin 2016).

The NGPF-G is a significant SWF globally due to its equity reserves as well as its size, as it owns about 1.2% of all globally listed securities and about 2.5% of all European-listed securities (Norges Bank Investment Management 2013).

The NGPF-G prides itself on being an ethical investor. Indeed, the NGPF-G is frequently described as an exemplary transparent investor in that it is answerable to the Norwegian public for its financial accomplishments. Apart from this, it has as its mandate an obligation to campaign for Norwegian values in the global arena and it endeavours to achieve this via advancing investor performance.

The Norwegian Ministry of Finance consistently publicizes its requests and discounts investment in the following types of firms: those that are weapons manufacturers, those that conduct business with such manufacturers, those whose actions negatively affect human rights, and those who participate in dishonest and other breaches of ethical norms or "severe environmental degradation" (Reiche 2010). The list of firms excluded includes tobacco manufacturers and palm oil producers, Walmart for concerns about labour (Dixon and Monk 2012; Pier 2007), and Cairn and Kosmos for a range of other ethical problems (Milne and Kiran 2016). From 2012 to 2014, the NGPF-G disinvested from 114 companies (Milne 2015). The Fund has voted in opposition to 15% of board agreements at annual shareholder meetings. Despite its comparatively minor ownership holdings, the NGPF-G is disposed to making its views seen and expects that they are attended to; it has not hesitated to exit from firms when its voice has not been heard (Goergen et al. 2017).

A key attribute of the NGPF-G is its predisposition to sell off its stake in companies whose activities it disproves of (Goergen et al. 2017). This penchant to exit may be about directing firms to operate correctly or in a defensible manner. However, the extraordinary attention paid by the Norwegian public as well as the political consideration of its performance may also make for overly short-term actions of its managers. Nonetheless, recent research has revealed that firms subjected to even quite small NGPF-G investments adopt a longer term approach to their people and

are significantly less likely to make use of redundancies (Goergen et al. 2017) nor has the fund followed its ethical policy only in negative lines, in other words, in avoiding ethically controversial firms. For example, for a number of years now, it has invested in the renewable energy sector, with the explicit purpose of encouraging the reduction of carbon dioxide emissions.

There are three key lessons from the experience of the NGPF-G. The first is that it is possible for an SWF to generate robust returns on its investments whilst following a strictly ethical agenda. Indeed, although the comparative evidence is limited, there is a case to be made that superior returns have been secured primarily through following an ethical agenda and through adhering to principles of good governance. The second is that greater transparency encourages ethical behaviours; there is little doubt that the NGPF-G has been held to its ethical brief through public debate as to the relative moral desirability of its investment strategies at home. The third lesson is that the pursuit of an ethical agenda is an open-ended project. Over the years, the definition of what constitutes an ethical investment has been tightened; ironically, this has now included a decision to divest from hydrocarbons (Wood et al. 2017).

Conclusion

SWFs provide a unique mechanism for husbanding a proportion of natural resource windfalls that may enable and equip future generations to secure their prosperity independent of remaining natural resource reserves and whatever their prices may do. At the same time, it can be seen that their activities raise a host of ethical issues. Firstly, their relative transparency varies greatly. Whilst it would be incorrect to say that all opaque SWFs are badly run or associated with the misallocation of their assets, in a few cases, this appears to be regrettably the case. Secondly, country of origin of these institutions plays a defining role on how SWFs operate. Thirdly, whilst SWF investments have far-reaching implications for employees and other stakeholders, there is little information on what precisely these effects are, other than in the case of Norway, where they appear to be beneficial. Finally, low and volatile oil and gas prices have

fed into the rapid diminishment of some SWFs, even if others, through continued forex inflows and/or better management, have grown. This would suggest a broad evolutionary process at play in the SWF ecosystem, which is likely to have far-reaching implications for both citizens of their countries of origin and stakeholders of firms they chose to invest in.

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