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ANALYSIS

Pension funds, corporate responsibility and sustainability

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ABSTRACT

The paper introduces two approaches to identify corporate behaviours that should attract the attention of pension funds in the context of debates over sustainability, while remaining within a narrow interpretation of their fiduciary duty. The approaches are based on two simple models of how different societal spheres interact with one another and influence long-term economic performance. These models allow exploring the idea that corporations can influence trajectories of societal change—keeping in mind that pension funds care about these trajectories because they care about the long-term performance of the economies in which they invest. The model underlying the internalising investor approach assumes that corporations are the only actors in society. In this model, pension funds will maximise their expected ability to meet their liabilities if companies internalise negative externalities and spill-over effects in order to reduce the cost of market failures for the economy as a whole. The model underlying the civic investor approach comprises companies and various actors (the state, NGOs, corporate stakeholders) engaged in shaping the governance structure that mediates the interaction between the social, environmental and economic spheres. In this model, pension funds will want companies to facilitate effective responses to societal problems. These approaches allow us to identify a number of corporate behaviours that should be of concern to pension funds.

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1. Introduction

Over the past few years, pension fund members, experts and policy-makers have expressed the view that pension funds have a special role to play in facilitating shifts towards sustainable societies, given their specific investment objectives and their nominal capacity to influence corporate conducts. These expectations have arisen out of the convergence of two societal trends. First, pension funds have become major shareholders in most major corporations—what Drucker (1976) called the “unseen revolution”. Second, the emergence of concerns over sustainability in the 1990s, combined with the perception that states are incapable of meeting the challenge alone, supports the proposition that private actors–including pension funds–will have to assume new responsibilities. And these expectations have been sufficiently strong to pave the way to the introduction of new legislation in various OECD countries.[1]

With some rare exceptions, pension fund trustees have generally been sceptical that they can indeed, or should, play this special role. In their view, to do so would violate their fiduciary responsibilities to their members, that is, the principle that their investment and ownership decisions should solely aim to enhance their members’ financial interests. Trustees’ scepticism thus hinges on the perception that the enhancement of pension fund members’ financial interests conflicts with an engagement of pension funds in the pursuit of sustainability.

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The main purpose of this paper is to show that, in some noteworthy circumstances, there is no such conflict and that, in the opposite, the fulfillment of pension funds' fiduciary responsibilities call upon them to exercise their influence on corporations and society in ways that promote sustainability. The thrust of the argument is the following: (1) pension funds' ability to meet their future liabilities is linked to the trajectory of societal change; (2) pension funds influence that trajectory through their investment decisions; (3) pension funds should aim to influence the economy and to promote those trajectories of societal change that will maximise their expected ability to meet their liabilities.

Following the logic of this argument, this paper identifies corporate behaviours that pension funds should be concerned about in the perspective of sustainability. We consider pension funds whose investment objective is to finance long-term liabilities (20 years or more) and we assume that they invest in a broadly diversified portfolio.

The paper introduces two complementary approaches that pension funds can follow to monitor corporate behaviours. These approaches are based on simple models of how different societal spheres interact with one another and which allow exploring the idea that corporations can influence trajectories of societal change.

Section 2 presents the internalising investor approach. The model underlying this approach assumes that corporations are the only actors in society. They influence the long-term return on capital through their impact on the social and environmental spheres (with social and environmental changes bearing back on the economy) and through the economy in the context of market failures. In this model, pension funds will maximise their expected ability to meet their liabilities if companies internalise negative externalities and spill-over effects in order to reduce the cost of market failures for the economy as a whole.

Section 3 introduces the civic investor approach. The implicit model underlying this approach comprises companies and various actors (the state, NGOs, corporate stakeholders) engaged in shaping the governance structure that mediates the interaction between the social, environmental and economic spheres. We assume that companies can influence the other actors and that society can reach various equilibriums that are determined by the capacity of society to respond effectively to new societal problems by putting in place the right governance structures. In this model, pension funds will maximise their expected ability to meet their liabilities if companies do not hinder or actively facilitate effective responses to societal problems.

Section 4 concludes with some remarks on methodologies to assess the contribution of companies to sustainability.

2. The internalising investor

2.1. Structure of the approach

Large institutional investors with a long-term investment horizon, such as pension funds, aim to maximise their expected ability to meet their liabilities. Given this objective, they are concerned about the long-term return on capital and, for this reason, about long-term economic growth. It follows that, assuming no changes in the institutional setting, investors may wish companies to internalise externalities and spill-over effects in order to enhance the performance of the economy as a whole. This is what we call the internalizing investors' approach.

In this section, we identify corporate responsibility issues of potential concern to investors according to this approach. To do this, we take long-term economic growth as a proxy for the long-term value of a widely diversified portfolio, consider a list of the main determinants of long-term growth established by gathering the results of the many studies carried out on this topic (see, for instance, Sala-I-Martin, 1997), and look for evidence showing that corporate behaviours bear on these determinants, starting with a comprehensive list of corporate responsibility issues provided by the Global Reporting Initiative (2002).

We distinguish between two categories of determinants of growth. First, we focus on determinants that lie in the social and environmental spheres: human capital, social capital, natural capital and political capital. The idea is that companies may have an impact on the long-term return on capital by fostering social and environmental changes, which, in return, affect the economy through interdependencies between the different societal spheres.

Second, we consider economic determinants of growth–physical capital, labour and total factor productivity–in relation to situations of market failure. Under conditions of perfect competition, full information and complete markets, corporate behaviours would not affect the long-term return on capital as the opportunities and resources not seized by one company would be picked up by other companies. Thus, companies may have an impact on the long-term return on capital by wasting capital, underutilizing labour and/or undermining total factor productivity, when there exist intra-economy market failures.

Our analysis yields a short list of corporate responsibility issues of potential concern for investors. In a second step not carried out here, the impact on the long-term return of capital of each issue on the list should be assessed carefully.

[1] Evidence of these expectations is numerous. Among policy-makers, see Annan (2003) in relation to global warming, and Short (2000) in relation to international development. Evidence of pension fund member expectations: Canadian Democracy and Corporate Accountability Commission (2002) found that, among the 2006 persons interviewed, 51% want their pension plans to invest in companies with a good record of social responsibility. For academic discussions, see among others: Kasemir et al. (2001), Monks (2001) and Kasemir and Süess (2002). Regarding legislation, the UK government has led the way with the passing in 2000 of an amendment to the pension act requiring pension fund trustees to disclose whether or not they take into account ethical, social and environmental criteria in their investment decisions. Similar legislation was subsequently passed in Germany (2001) and Australia (2001), and is being discussed in Austria, Belgium, Canada, Denmark, Italy and Spain. In its white paper on corporate responsibility, the European Commission (2002) invited occupational schemes to adopt similar practices. For a general review of the role of public policy in promoting CSR, see Aaronson and Reeves (2002).

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