

THE ART OF THE POSSIBLE: SOCIALLY RESPONSIBLE INVESTMENT AND STATE PENSION PLANS

By Joel Davison Harden
Department of Social and Economic Policy, Canadian Labour Congress

Executive Summary

Concerns around Socially Responsible Investment (SRI) for the assets of state pensions have preoccupied decision-makers and citizens worldwide for decades. In some countries, as we review below, such concern has prompted concrete action. In Canada, the Canadian Pension Plan Investment Board (CPPIB) recently produced a Policy on Responsible Investment, and the move has spurred significant debate.¹

At issue is how state pensions - as some of the largest pools of capital on the planet - can influence global business to shed its focus on short-term profit at any cost.² Advocates of SRI claim mandatory state pensions, as obvious pools of workers' capital, should provide a leadership role in rejecting such 'short-termism'. In contrast to prevailing financial wisdom, state pensions should help create a vibrant and sustainable world economy.

Inspired by such reasoning, critics in recent years have questioned the CPPIB's investments in the tobacco industry, weapons producers, and firms with questionable (or reprehensible) corporate practices.³ As critics have explored alternatives, questions have been raised about the SRI practices of state pension plans outside Canada. Many have agreed that further inquiry into this subject would help the CPPIB implement (and potentially improve) its stated Policy on Responsible Investing.

¹ More detailed discussion of this Policy is provided below. See: CPPIB, "Policy on Responsible Investing" (October 13, 2005), www.cppib.ca.

² The Canadian Pension Plan was among many state pensions during the 1990s to switch from financing itself on a yearly basis (or "pay-as-you-go" funding) to a "fully funded" system of financing. Under the "fully funded" model, state pensions opted to create reserve funds that invested in various indexed stocks, and to use returns on investments to expected increases in pension costs.

³ See: Peter Gillespie, "Your Pension Contributions at Work?", *The Toronto Star* (December 22, 2005).

This brief paper attempts to partly fill this research gap. Following some preliminary investigation, the SRI criteria of three state-sponsored pension plans were chosen as decent examples to compare with the CPP. These included:

1. The Fonds de Réserve pour les Retraites (FRR) in France;
2. The Norwegian Government Pension Fund (formerly known as the Oil Fund);
3. The New Zealand Crown Financial Institutions (CFIs).

All of these examples differ somewhat in size from the CPP,⁴ but each has grappled with the question of SRI. All have faced criticism in their implementation of SRI, but have made some strides in their use of 'extra-financial considerations' (to use the industry term) for pension fund investment. A brief analysis of each is provided below, followed by a discussion of the implications for SRI with the CPPIB.

The Fonds de Réserve pour les Retraites (FRR)

The FRR itself was created in 1999 with the stated objective of easing the coming 'demographic crunch' of retiring baby boomers in France. The idea behind its creation, one repeated in other countries, was to use investment returns to help finance state pensions.

The guardians of the FRR oversee roughly E\$23 billion (E for 'Euros'), and have recently hired five 'SRI mandates' valued at E\$600 million each. Investment fund managers were chosen based on their ability to deliver technical expertise, priorities close to the FRR's stated SRI objectives, and competitive management costs. These mandates were hired on a five year basis, and promoted as part of the FRR's attempt to join an SRI investment community that "is becoming increasingly mature in Europe."⁵

⁴ As of February 2006, the CPP reserve fund held CAD\$92.5 billion, and stood as the 22nd largest retirement plan worldwide. Altogether, as of December 2005, state pensions and local government retirement funds comprise an asset base of over USD\$2.66 trillion worldwide. See: "CPP Reserve Fund Grows to \$92.5 Billion" (February 8, 2006), www.cppib.ca; "P&I/Watson Wyatt World's 300 Largest Retirement Plans", *Pensions and Investments* (December 26, 2005).

⁵ FRR, "Press Release" (April 25, 2006), www.fondsdereserve.fr.

Overall, the FRR Board claims its interest in SRI comes from the fact that it was established to serve the 'general interest'. As a result, its investment strategy states that "...the FRR's investment policy has a dual aim. On the one hand, it seeks to maximize investment returns over the long term and under the best possible conditions of security. Its investment policy must also be consistent with certain shared values that promote economically, socially and environmentally sustainable development."⁶

In applying these general principles, the FRR Board looks at three broad strategies: a) an active policy of voting proxies at shareholder meetings of firms where the FRR invests; b) requiring its investment fund managers in European equity markets to develop 'extra-financial' considerations, particularly concerning the ten principles of the UN's Global Compact;⁷ c) developing SRI by establishing the six SRI mandates outlined above.

In addition to this, the FRR has also added four additional investment guidelines for fund managers: a) respect for international law and basic worker rights; b) job development through better management of human resources; c) corporate environmental responsibility; d) respect for consumers and fair trade in local markets.

The FRR Board has decided against excluding certain investment sectors entirely (tobacco, the arms trade, etc.). Instead, it encourages fund managers to screen investments out of step with the FRR's SRI principles.

⁶ FRR, "The FRR's SRI Investment Strategy and SRI Mandate Philosophy" (June 2005), www.fondsdereserve.fr.

⁷ The Global Compact is a voluntary set of standards for corporate behaviour, and encourages firms to embrace ten principles: human rights as identified by international covenants; avoiding complicity in human rights abuses; workers' right of association and collective bargaining; the elimination of all forms of forced labour; the elimination of child labour; the elimination of discrimination in employment and occupation; a precautionary approach to environmental challenges; initiatives to promote greater environmental sustainability; encourage the development and diffusion of environmentally friendly technologies; work against all forms of corruption, including extortion and bribery. See: UN, *United Nations Global Compact* (January 31, 1999) www.unglobalcompact.org.

The Norwegian Government Pension Fund (NGPF)

The NGPF was recently formed January 1, 2006 as a merger of previously existing Government Petroleum Fund and the National Insurance Scheme Fund. As of January 1, 2006 the larger Fund is split into two parts: “The Government Pension Fund – Global”, and “The Government Pension Fund – Norway”.

The NGPF is one of the world's largest pension funds (with over USD\$207.4 billion under management), and most of its revenues come from oil extraction. Norway is the third largest oil exporter in the world (behind Saudi Arabia and Russia), and the first principle of the NGPF involves ensuring this wealth benefits 'future generations' through investments that create a 'sound return' in the 'long-term'.⁸ The second principle of the NGPF states that the Fund should take no 'unacceptable risk' as a result of choosing investments with companies which engage in human rights violations or have a record of environmental degradation.

In the Spring of 2004, the Norwegian Stortinget (Parliament) heard considerable debate around the publication of an SRI report chaired by Hans Petter Graver, a Professor of Law at the University of Oslo.⁹ The Graver Report recommended, among other things, an active policy of screening stocks on certain issues of 'national importance' (land mines and nuclear weapons were specifically mentioned), and for UN Conventions to be understood as legal contracts for the investment of state pensions. It decided against choosing its own list of SRI guidelines, choosing instead the 'overlapping consensus' through international accords for basic human rights and environmental safeguards.

⁸ Government of Norway (Ministry of Finance), “The Government Pension Fund” (March 2006), www.odin.dep.no/fin/engelsk.

⁹ Government of Norway (Ministry of Finance), “The Petroleum Fund – Management for the Future: Proposed Ethical Guidelines for the Government Petroleum Fund” (January 2004), www.odin.dep.no/fin/engelsk.

On the whole, the Graver Report was provocative in its rhetoric, evidencing the philosophy that would shape the NGPF's approach to SRI:

It is a well-known fact that by exhausting the earth's resources and eroding the conditions for life on the planet, we may be achieving prosperity now at the expense of the prosperity of future generations. Fossil fuels in particular cause problems since greenhouse gases are released during their production and use. Furthermore, while our prosperity grows, many people in other parts of the world live in poverty and need. In some cases, commodities and services for our consumption are produced by workers who are grossly exploited. The ecology of our planet is not likely to be able to withstand other countries copying the economic and technological developments we have experienced in order to close the gap between rich and poor. The way in which we generate and distribute wealth is important if we are to share the earth's resources fairly and avoid jeopardizing the prosperity of future generations.¹⁰

The NGPF has delivered on some of these grounds in its decision to screen out certain manufacturers of cluster bombs, nuclear weapons, and, most recently, Wal-Mart and Freeport (Freeport is one of the world's largest mining firms).¹¹ These actions are without peer in the SRI community, and have been taken in accordance with the NGPF's principles around fostering a sustainable economy for future generations.

Critics, however, have complained that the Fund's SRI criteria leaves gaps for public relations firms to salvage the reputations of firms accused of wrongdoing. Under the NGPF's rules, it is not enough to establish that a firm has already contravened accepted human rights and environmental standards; it is also important to establish that a firm is likely to commit similar acts in the future.

¹⁰ See: Ibid., "Two Companies—Wal-Mart and Freeport—are being Excluded from the Norwegian Government Pension Fund's Investment Universe", (June 6, 2006), www.odin.dep.no/fin/english/news.

¹¹ See: Pia A. Gaarder, "Cluster Bombs and Nuclear Weapons Out of Oil Fund" (November 11, 2004), www.justmake.no.

Currently, the NGPF is facing sharp criticism for continuing its investment in the French oil firm Total despite the latter's historical relationship with Burma's military dictatorship. Activists allege that the NGPF is reluctant to divest from Total because of its significant presence in Norwegian oil development, a charge the NGPF hotly denies.¹²

New Zealand's Crown Financial Institutions (CFIs)

New Zealand's five CFIs,¹³ taken together, represent over USD\$14.7 billion in investment capital (they are expected to grow to between USD\$73.8 – USD\$92.3 billion by 2025). While the specific language differs in the policy documents of each CFI, a commitment has been made that investment practices would “avoid prejudicing New Zealand's reputation as a responsible member of the world community.”¹⁴ For example, the policy documents of the NZ Superannuation Fund (NZ Super) explain the Fund Guardians¹⁵ are empowered to divest or screen out investments

...widely regarded internationally as having participated in gross abuses of fundamental human rights; or serious infringements of labour and employment standards; or serious infringements of environmental standards; or promoting transnational organized crime or terrorism; or other conduct which is so reprehensible that it may prejudice New Zealand's reputation as a responsible member of the world community or

¹² Pia Gaarder, “Nystuen Denies Pressure in Assessment of Total” (March 29, 2006), www.justmake.no.

¹³ The New Zealand Superannuation Fund (state pension), the Government Superannuation Fund, the National Provident Fund, the Accident Compensation Commission, and the Earthquake Commission. Four of these, of course, have nothing to do with pensions per se. For simplicity's sake, however, they will be grouped in this paper in references to 'state pensions'.

¹⁴ Remarks by Dr. Michael Cullen (Deputy Prime Minister, Minister of Finance, Minister for Tertiary Education, Leader of the House for the Government of New Zealand), “Reward, Risk and Reputation: Re-Thinking the Investment Role of CFIs in New Zealand's Growth” (December 2, 2005), www.csri.org.nz.

¹⁵ This is an industry term that refers to officials responsible for ultimately making policy decisions in pension fund investment.

its reputation as a responsible investor in sovereign and corporate securities.¹⁶

NZ Super, like the French FRR and Norwegian NGPF, states that it prefers an approach of 'engagement' with problematic investments rather than screening certain investment sectors altogether. Interestingly enough, however, NZ Super has yet to engage any company given SRI concerns. Two other CFIs - the Accident Compensation Commission and the Earthquake Commission - have opted to screen certain investments after reviewing questionable practices.¹⁷ In each case, the decision to divest came primarily from a perception that the investment posed a threat to the growth potential of the CFI.

This track record has led critics to claim the commitment of the CFIs to SRI is muddled at best. Dr. Robert Howell - Chairperson of the New Zealand Council for Socially Responsible Investment - recently released a report detailing the extent of the CFIs investments in "...tobacco companies, and companies with unacceptable or questionable human rights behaviour or environmental impacts, such as Nike, Wal-Mart, BJ Services (operating in Burma) and Exxon Mobil."¹⁸ The problem, Howell suggests, is that "the meaning and use of the 'international reputation' criterion is so vague and useless, that the criterion makes no difference between agencies that solely invest for only financial returns."¹⁹

Contentious Issues: Inconsistent Use of SRI , 'Fiduciary Duties'

¹⁶ New Zealand Superannuation Fund, *Statement of Investment Policies and Procedures* (May 2005), www.superfund.co.nz.

¹⁷ Divestments have largely happened in pharmaceutical companies for producing dangerous drugs, and other firms given unethical marketing practices. In one instance, however, the Earthquake Commission did ask one of its fund managers to encourage "Safeway and Kroger, both US companies, to have open and honest dialogue with union leaders." See: Remarks by Dr. Robert Howell, "The New Zealand Crown Financial Institutions' Non-Financial Investment Criteria" (December 2, 2005), www.csri.org.nz.

¹⁸ Ibid.

¹⁹ Ibid.

As the cases of the FRR, NGPF and CFIs illustrate, a gap remains between workers' expectations and the track record of state pensions espousing a commitment to SRI. While some progress has been made in engaging or screening certain investments, the application of SRI across state pension investments has often been inconsistent.

The NGPF is an instructive case in point. While the NGPF has done more than anyone to screen certain weapons producers, it has yet to make any inroads against the conventional weapons industry servicing wars of aggression. Its further inconsistent approach in reviewing Total's human rights record in Burma is similarly of concern.

Interestingly enough, it would appear that SRI arguments warning of profitability risks from poor corporate practices have been most persuasive for decision-makers in state pension funds. This was definitely the case in France and New Zealand, and studies suggest similar arguments have persuaded large workplace pension funds to take action around SRI.²⁰

It is definitely worth considering a pragmatic approach to pension fund activism that stresses irresponsible investment as a financial risk to state pensions. By doing so, one can undercut the common argument used to reject SRI: that it conflicts with the 'fiduciary duty' of Fund Guardians to maximize investment returns. On the contrary, a recent, detailed multinational study (conducted for the United Nations Environmental Programme by Freshfields, a leading British international law firm) illustrates the precise opposite is true. Given its remarkable conclusions, the report is worth quoting at length:

There is...no reason why investment strategies should not include investments with positive ESG [environmental, social and governance] characteristics. The important limiting requirement is that imposed by the duty of loyalty: all investment decisions must be motivated by the interests of the fund's beneficiaries and/or the purposes of the fund. No investment should be made purely to give effect to the personal views of the decision-maker. Instead, all considerations must be weighed and

²⁰ See: William Grieder, "The New Colossus: The New Politics of Capital", *The Nation* (February 24, 2005).

assessed in the context of their expected impact on the investment portfolio.

Moreover, as with all considerations, ESG considerations must be taken into account wherever they are relevant to any aspect of the investment strategy (including general economic or political context, expected tax consequences, the role that each investment plays within the overall portfolio, expected risk and return, and the need for liquidity and/or capital appreciation). In addition, where the beneficiaries have expressed investment preferences in the fund instrument or otherwise, these preferences should also be taken into account. In short, there appears to be no bar to integrating ESG considerations into the day-to-day process of fund management, provided the focus is always on the beneficiaries/purposes of the fund and not on unrelated objectives.²¹

Taken to its logical conclusion, the UNEP-Freshfields study provides the necessary legal justification for a ready application of SRI to state pensions, or workplace pensions too for that matter. If Fund Guardians can establish they are “acting in the best interest of plan beneficiaries” (in the CPPIB's case, Canadian citizens), SRI makes perfect sense in the narrow universe of the pension industry.

To cite a specific case, Fund Guardians could see it as their fiduciary duty to engage Wal-Mart's corporate practices given the financial damage to investments from pension funds. This is precisely the reasoning that went into a recent letter to Wal-Mart's Board of Directors by four major institutional investors who collectively hold over 11.5 million in company shares (valued at USD\$550 million).²²

Citing Wal-Mart's regulatory non-compliance with labour standards in the US, the authors demanded a thorough review of company controls by independent directors. Wal-Mart responded to the letter by claiming it would take action but, as yet, the company has done nothing. The authors also

²¹ United Nations Environmental Programme, *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment* (October 2005), www.unep.org.

²² See: “Investors Raise Governance Concerns at Wal-Mart”, *Financial Times* (June 1, 2005).

suggested further shareholder action was likely in the event such inaction persists. Interestingly enough, as Wal-Mart has been recently battered with court settlements around unfair labour practices, its share price and sales volume has dropped accordingly. In response, as a partial indication critics are having an impact, Wal-Mart has embarked on a vigorous campaign to raise its corporate profile.²³

The CPPIB's Policy on Responsible Investing has also led to creating a like-minded interest in pursuing SRI. While claiming that the “overriding duty of the CPPIB is to maximize investment returns without undue risk,” the Policy acknowledged that SRI seeking to enhance long-term corporate performance was beneficial. The Policy has not fully satisfied its critics, but it does offer a basis for further discussion.

Significantly, the Policy committed to building the CPPIB's “engagement capability” to improve corporate performance and disclosure around SRI concerns. The CPPIB also claimed it was reviewing various international accords “that will act as platforms for engagement”, and that it intended to hire a new manager to oversee the use of this policy. Subsequent to the release of the Policy, the CPPIB announced its new membership in the Enhanced Analytics Initiative, a service provider that recommends sources for investment research on 'extra-financial' considerations.

Conclusion: Identifying the 'Art of the Possible' for SRI and State Pensions

Without question, the case for SRI in state pension funds is a powerful one. Assets derived from the mandatory retirement contributions of working people should be a leader in encouraging sustainable development and sound corporate practices. When asked, most Canadians support the notion that public pensions should promote these objectives.

²³ H. Lee Scott Jr., Wal-Mart's CEO, recently explained to a business report that “When growth was easier, this idea of critics simply being ignored was O.K. [But] as the share price slows, you have to get to this point.” See: Robert Berner, “Can Wal-Mart Wear a White Hat?”, *Business Week* (September 22, 2005).

The FRR, NGPF, and CFIs, despite their contradictions, are ahead of the CPPIB on this issue. Still, with the events of recent months, there is reason to believe the CPPIB is open to discussions around implementing its work around SRI. The CPPIB's Policy on Responsible Investing indicated it plans to “work with other parties to develop solutions that support ESG factors.”²⁴

Even before the Policy was released, however, the CPPIB had divested from firms producing land mines given Canada's commitments under international accords.²⁵ This precedent clearly indicates similar action is possible where one can demonstrate a disconnect between the CPPIB's investment policy and Canada's support of global covenants. It is strongly recommended, then, that a key aspect of upcoming work with the CPPIB involve sharing research that points out such discrepancies. Anti-smoking advocates and the federal New Democratic Party have also asked the CPPIB to honour Canada's international accords around the practices of the tobacco industry.²⁶

In light of events in France, Norway, and New Zealand, it is clearly worth examining the potential for CPPIB engagement in (or divestment from) particular firms that violate Canadian or international standards in human rights and environmental protections. The case of Wal-Mart is an obvious one, but equally relevant are Canadian firms (like SNC-Lavalin) that have supplied weaponry to the current US-led occupation of Iraq, a military invasion that circumvented clear guidelines under international law.²⁷ Firms supplying the dictatorial regime in Burma are also worthy targets for engagement or divestment. Canada is the also place where mining firms raise capital for their operations in global jurisdictions, many of which have a terrible record for workers rights and environmental degradation.

An important process of targeting certain 'worst offenders' will be important in encouraging the CPPIB to use its SRI criteria seriously. Given the

²⁴ CPPIB, “Policy on Responsible Investing”.

²⁵ Physicians for a Smoke-Free Canada, “Treaty Ratification Clears Way to CPP Tobacco Divestment” (December 16, 2004), www.smoke-free.ca.

²⁶ Ibid

²⁷ See: Chris Spannos, “Canadian Bullets, Dead Iraqis” (September 8, 2004), www.zmag.org.

experience elsewhere, it is well-worth investigating the art of the possible here, and it is surely a good sign that CPPIB officials have indicated a willingness to consider international accords in shaping SRI choices. Thinking about SRI in these terms, as an art requiring sound application, provides the most useful platform to help the CPPIB in its work.

In many respects, asking global markets to move beyond 'short-termism' seems like asking a leopard to change its spots. For that reason, a healthy dose of pragmatism should be exercised in offering a rational voice to an otherwise irrational domain. Nevertheless, the investment decisions of state pensions can (and should) play a role in seeking to create a more just world. Some countries have decided to forge ahead on this front, and, despite their shortcomings, they are to be congratulated for doing so. Pension officials must remain mindful of the world we plan to retire into, and the implications of investment choices in that context.

JH:sm*cope225 (June 2006)

C:\Documents and Settings\ffitzgibbon\Local Settings\Temp\Harden_SRI & State Pensions_7-06.wpd