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Pension Funds, Sovereign-wealth Funds and Intergenerational Justice

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Pension Funds, Sovereign-wealth Funds and Intergenerational Justice

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Abstract: Pension funds and sovereign-wealth funds own a large and increasing fraction of the shares in publicly traded companies in the OECD area. These funds typically have a very long time horizon on their investments, as well as highly diversified portfolios. These features imply that the interests of these funds on important issues are aligned with the interest of future generations because the long-term return on a highly diversified portfolio will depend on the degree to which the development of the world economy is sustainable. It is, therefore, in the enlightened self-interest of these investors to use their shareholder rights so as to protect the interest of future generations. The paper explores the arguments for a more active corporate governance policy among pension funds and sovereign-wealth funds and discusses the obstacles to such policies.
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1. Introduction

In this paper, we argue that investment funds that have a very long time horizon and a diversified portfolio can potentially play a significant role in promoting intergenerational justice. Pension funds are the most important type of such funds, but, typically, sovereign-wealth funds also have the same characteristics. These types of funds represent an increasingly important group of shareholders and we shall argue that the financial interest of these funds is well aligned with the economic interest of future generations.

The capital managed by pension funds and sovereign-wealth funds has been rapidly increasing during the last decades. In some countries, like the USA, pension funds alone own a majority of the shares in listed companies. The social and environmental policies pursued by the companies where pension funds are shareholders have a significant impact on the social and environmental development of the world economy. To the extent that owners actually control the companies they own, such investors can thus be a very important force for a more sustainable development if they decide to use their shareholder rights to influence the environmental and social policy of the corporations they own.

This paper explores the arguments for a more active corporate governance policy among pension funds and sovereign-wealth funds. It also describes some of the main obstacles to effective shareholder democracy. The main argument in this paper is that these obstacles prevent pension funds and investors with similar interests from using their influence to promote sustainable development. Furthermore, we argue that changes in the corporate governance structure that improve these investors' ability to control the companies they own might promote intergenerational justice.

2. The Growing Importance of Pension Funds and Sovereign-wealth Funds

In 1994, pension fund assets amounted to 5.9 trillion USD in the OECD. By 2011, the total assets of pension funds within the OECD were estimated at 18.6 trillion USD. The US, the UK, Japan, the Netherlands, Australia, Canada and Switzerland dominate the pension fund market, and, in aggregate, these markets account for more than 90% of the assets managed by pension funds in the OECD. (All data is from "OECD Pension Markets" in *Focus*, Issues 1, 2 and 8.)

The OECD expects the growth rate of pension funds to accelerate further over the coming decade as both the public and private sectors intensify efforts to prepare themselves for the rapid ageing of the population. One important reason for this is that many countries that traditionally have financed pensions with a pay-as-you-go system are now starting to fund their own pension systems. In some countries, predominantly the US, Norway, Japan, Korea and Sweden, savings in social security reserve funds represent a substantial part of their long-term savings. The assets managed by pension funds are likely to continue to increase in the years ahead. However, the importance of pension funds as shareowners also depends on the share of total assets allocated to equities, i.e., to types of securities that represent ownership in a company. The average allocation to equities varies, but, in some major markets like the Netherlands and the UK, the allocation is above 50%, while in the US it is about 30%. In the majority of the other countries, more than 50% of the assets are allocated to bills and bonds. The allocation to equities may decrease in European countries due to the requirements on balance sheet volatility.[1] However, the most likely scenario is that pension funds will increase their relative importance as owners.

Sovereign wealth funds have also become more important. These funds are, broadly defined, entities that can manage the national savings for the purposes of investment. Many of the most important sovereign-wealth funds, such as the Abu Dhabi Investment Authority, The Norwegian Government Pension Fund – Global and the Kuwait Investment Authority, have their origin in oil revenues and their aim is to ensure that future generations also benefit from the large oil revenues. In the context of intergenerational justice, these funds are therefore particularly important. According to the report "Sovereign Wealth Funds 2012" published by theCityUK[2], sovereign wealth funds have a market capitalization of about $4.8 trillion. Even though this number is highly uncertain, it illustrates that funds with an explicit focus on intergenerational justice are becoming a significant group of owners.

[1] The investment of assets of a pension fund constitutes one side of a pension fund's balance sheet, while the pension funds liabilities constitute the other. The value of the two sides fluctuate differently and, in most countries, there are strict rules on how a pension fund should control the relationship between the two sides of the balance sheet, i.e., the balance sheet volatility. The increased funding requirements for US plans may also negatively impact the allocation to equities. There is also an increase in allocation to alternative investments like real estate. On the other hand, pension funds have increased their diversification in foreign markets in recent years, especially in countries where pension fund assets show a high ratio to GDP, like the US, the UK and the Netherlands. Countries that used to have limits on foreign investments may have reduced them or eliminated them completely. This is, for example, the case with Canada, which used to have a limit of 30%.

[2] www.thecityuk.com/research/our-work/reports-list/sovereign-wealth-funds-2012/

3. Intergenerational Justice

There are two reasons why the increasing size of pension funds and sovereign-wealth funds are important for intergenerational justice. First, there is a direct link between intergenerational justice and the size of these funds because these funds represent private and national savings. Future generations benefit from high savings today because high savings imply less consumption by the current generation and more investment that will benefit the future generation.

In this paper, we are, however, primarily concerned with a second indirect link between these funds and intergenerational justice. The growth of pension funds and sovereign-wealth funds means that these funds potentially get more influence as owners, i.e., that their ability to affect the corporations of which they are owners increases. How these funds use this influence will in turn affect the development of the world economy. In particular, we shall argue that these funds will contribute to reducing one important source of intergenerational injustice, which we might refer to as intergenerational externalities. Externality occurs when a decision has unintended consequences for a third party; and intergenerational externalities are the unintended consequences on future generations of decisions made today.

An important type of intergenerational externalities arise when the actions corporations take today create costs for future generations and when these costs are not taken into account by the corporations. A much-discussed example of such externalities is the effects on future generations of greenhouse-gas pollution. Emissions of greenhouse gases due to human activities alter the atmosphere in ways that are expected to affect the climate. The cost of climate change will be primarily carried by future generations.

The primary reason why the consequences for future generations are not taken into account by corporations is that these corporations typically focus on the return on their assets in the short and medium term. We shall argue that pension funds and sovereign-wealth funds, as shareholders in these corporations, have incentives to at least partly internalize such intergenerational externalities. The reason for this is the combination of two important features: a highly diversified portfolio and a very long time horizon.

Institutional investors are what Hawley and Williams (2000) have described as "universal owners" who have a significant stake in a broad cross-section of the largest publicly traded firms in the economy. To illustrate, consider the case of the Norwegian Government Pension Fund – Global. This fund is not formally a social security reserve fund, but its investments are likely to be used to meet the liabilities of the Norwegian public pension system in the future. This fund is one of the largest singly owned institutional funds in the world with a portfolio of close to 600 billion dollars and investments in approximately 7,800 companies in close to 70 countries. Since these companies are among the largest in the world, they constitute approximately 90% of the total value of publicly traded companies on the world's major stock exchanges.

Large pension funds and sovereign-wealth funds, such as The Norwegian Government Pension Fund – Global, are not primarily interested in the profitability of single companies. They are interested in the return on their total portfolio, which will depend on the overall ability of the equity markets to deliver good absolute returns. This ability will in turn depend on how well the markets function. Market failure, for example, due to the existence of externalities, might benefit individual companies, but it will not benefit the economy as a whole. It is therefore in the economic self-interest of such funds to support private and public initiatives to reduce or eliminate market failures.

The second feature of pension funds and sovereign-wealth funds is their long time horizon. This is an obvious feature of sovereign-wealth funds that are often explicitly established in order to save wealth for future generations, but it is also an important feature of pension funds. When people save in pension funds they will typically not start to withdraw the money they have saved before they retire. This means that often the beneficiaries of the pension funds will have their money invested for several decades. The funds beneficiaries are interested in the value of their investment when they withdraw their money and this implies that the pension funds should have a long time horizon in order to promote the interest of their investors. Since there will typically be overlapping generations invested in the same pension fund – and new generations will replace older generations as the older generations withdraw their money – this is a permanent feature of most pension funds. To illustrate, let us consider again the case of the Norwegian Government Pension Fund – Global. It is likely to take many decades before the money put into the fund today is used by its beneficiaries and the primary beneficiaries of this fund are the future generations of Norwegians. There are few, if any, economic agents in the stock market who have an equally long time horizon as pension funds and sovereign-wealth funds.

The combination of a diversified portfolio and a long time horizon creates incentives to internalize intergenerational externalities. Pension funds are thus primarily concerned with the absolute long-term return on their portfolio. The long-term return of a diversified portfolio will in turn depend on the long-term development of the world economy. Since it is impossible for such investors to have a high long term return on their investments unless the world does not develop in a sustainable manner, it is in the self-interest of these investors to promote sustainable development. They have an incentive to engage in questions that have a long-term, broad applicability to the functioning of markets, without necessarily being linked (at least not directly) with the performance of individual portfolio companies.

To see the implications of such incentives, consider again the case of negative environmental externalities such as the risk of climate change caused by emissions of greenhouse gases. A company responsible for large emissions of greenhouse gases will, in the absence of any regulations, only face a small fraction of the real societal cost. It might, therefore, be profitable for a company that is a large polluter to lobby against any environmental regulation that increases the cost of emissions. The resistance among certain big corporations against various environmental initiatives has been an important reason why it has been so difficult to get effective reforms. It is, however, not in the interest of pension funds and sovereign-wealth funds that such market failures remain, even if they are shareholders in a polluting company, because they will also own shares in many other companies that in the future might be negatively affected by the emissions. Cheap emissions might, in other words, be of great value for individual companies in the portfolio, but might, at the same time, represent a significant cost to the portfolio as a whole. As a result, it is, for example, not in the interest of pension funds to allow companies in their portfolio to lobby against reforms that will reduce the level of greenhouse emissions. The same argument can be made with respect to other types of market failure that create intergenerational externalities.

A large and increasing fraction of the pension funds and sovereign wealth funds have explicitly acknowledged that their long-term interests are linked to sustainable development. One expression of this commitment is that funds, such as the Norwegian Government Pension Fund – Global, CalPERS, Hermes, USS, TIAA-CREF, and ABP, have introduced ethical guidelines that express the expectations they have towards they companies where they are shareholders.[3] An important emphasis in these guidelines is typically on the obligations companies have to protect human rights, and to promote a more sustainable development of the world economy.

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[3] http://www.norges-bank.no/nbim/corporate.html
http://www.calpers-governance.org/principles/global/globalvoting.pdf
http://www.hermes.co.uk/pdf/corporate_governance/Hermes_Corporate_Governance_Principles_web_030306.pdf
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http://www.abp.nl/abp/abp/vermogensbeheer_en/key_navigatie/Sustainable_Investments/default.asp?menu=5

4. Shareholder Democracy and Corporate Governance

While sustainable development is in the interest of pension funds and sovereign-wealth funds, this interest is not necessarily shared by other shareholders with less diversified portfolios or with a shorter time horizon. These funds can therefore not rely on others to ensure that their interest in a sustainable development is taken into account by the management of the companies where they are shareholders. If these investors want to influence corporations to improve social and environmental standards they therefore have to exercise their shareholder rights.

Shareholders, as owners of corporations, have several rights that enable them to govern corporations, either directly or through their elected representatives on the board of directors. The voting rights on the annual general meeting are the most important of these rights. However, the efficient use of such voting rights requires that shareholders also have the right to make proposals at the general meeting and the right to receive timely, adequate and correct information from the company. We shall refer to these three types of rights as “democratic rights,” and refer to the exercise of these rights as shareholder democracy.

Shareholder democracy is a central part of corporate governance, i.e., it is a central part of the different processes by which a corporation is governed. The most important function of shareholder democracy is to elect the board of directors and to vote on decisions of fundamental importance to the corporation. A well-functioning shareholder democracy must at least ensure that the board of directors consists of qualified persons who promote the interest of all shareholders and who are able to effectively control the management of the company.

It is a generally accepted principle that the shareholders should be able to influence all major decisions in the company, in particular, the composition of the board, through the exercise of their voting rights. Shareholders’ ability to influence such decisions is, however, often curtailed in several ways (Bainbridge (2006) and Bebchuk (2005)). Several challenges to a well-functioning shareholder democracy can be identified.

A first set of challenges to shareholder democracy concerns transparency and the right to information. In order to protect their ownership interests, including the interest in a sustainable economic development, it is crucial for shareholders to receive timely and adequate information about the company’s affairs. This is unfortunately often not the case. For example, information on the agenda for the general meeting is frequently so late and deficient that it is impossible for the shareholders to make well-founded decisions about how to vote in the general meeting. Furthermore, information provided about the social and environmental impact of the corporation’s activities is often inadequate or non-existing.

A second set of issues concern practical barriers to voting. Many institutional shareholders do not use their right to vote at company general meetings because complexity of cross-border voting mechanisms discourages foreign institutional shareholders from voting, and because the chain of financial intermediaries between the company that issues the shares and the investors translates into high voting costs. Furthermore, in a number of markets, especially in Europe, the shares of an investor who wishes to vote will be blocked, i.e., the investor will not be permitted to trade the shares for a set period of time or until the meeting is over. Since institutional investors want to maintain their freedom to sell their shares without restrictions, this often means that they choose not to exercise their voting rights.

A third set of issues concerns the distribution of voting rights. It is a common view that shareholders' voting rights should accrue in accordance with the equity capital commitment to the company. Deviations from the “one-share-one-vote” principle take many forms, including dual share classes, voting caps and golden shares. In the US, most publicly listed companies follow the "one-share-one-vote" principle, meaning that each share carries the same voting right. In Europe, large shareholders who control a majority of the voting rights without owning the majority of the equity capital dominate one-third of the companies in the FTSE Eurofirst 300. The most common deviation from the one-share-one-vote principle in European companies is dual class structures. Other forms of deviations are voting and ownership ceilings, priority shares and golden shares. Common to most of these deviations from the one-share-one vote principle is that they allow a minority of the shareholders to maintain control of the company. This implies that pension funds and sovereign-wealth funds, which are typically not controlling shareholders, have less influence on the company. Pyramidal structures and cross-holdings, which are common in both Asia and in some European markets, are other means by which a minority owner can secure control of a company (Almeida and Wolfenzon, 2005).

A final set of issues concerns the way in which corporate directors are elected. In many companies, the composition of the board is effectively determined either by the management or by a minority of large shareholders. This is a problem particularly in the US market because shareholders are effectively prevented from nominating board members. Shareholders who oppose the election of a particular candidate can express their dissent by withholding their vote. However, in many companies, directors are elected even though a majority of shareholders withhold their votes. The fact that the directors do not depend on shareholder support to be elected leads to a lack of accountability.

Taken together, the result of these impediments to effective shareholder democracy is that pension funds and sovereign-wealth funds have much less influence over the publicly listed companies than their ownership share should imply. Since the interests of these funds are well aligned with the interests of future generations, this democratic deficit is also a problem for intergenerational justice.

5. The New Role of Institutional Investors

Pension funds and sovereign-wealth funds are increasingly realizing that they need to play a more active role in the shareholder democracy in order to promote their interest as long term investors with diversified portfolios. This implies, as a minimum, that they have to use their voting rights at the general meeting. However, an effective corporate governance strategy would also have to involve an active dialog with the management and a willingness to make shareholder proposals.

Pension funds and sovereign-wealth funds should also engage in corporate governance activities to improve the shareholders' ability to govern the companies they own. In order for pension funds and sovereign-wealth funds to effectively use their shareholder rights, important reforms must take place in the corporate governance system in many markets. Most importantly, the ability for shareholders, in particular foreign institutional shareholders, to use their voting rights must be improved and the process of determining the composition of the board must be improved.

Such reforms will only take place if pension funds and sovereign-wealth funds collaborate. There are many examples of increased collaboration among institutional investors. One example is the increased interest in the many formal and informal corporate governance networks among institutional investors that exists, such as the International Corporate Governance Network with more than 500 members holding assets exceeding $18 trillion, as well as investor support to more specific initiatives, like the Carbon Disclosure Project (CDP) and ad-hoc collaboration among investors around important company events.

An increase in cooperation can be seen on issues related to responsible investment. There are 655 institutional investors worldwide who have joined the Carbon Disclosure Project managing in excess of US$78 trillion in assets. The Investor Network on Climate Risk has grown from 10 institutional investors managing $600 billion in 2003, to 100 members managing nearly $10 trillion in assets today. The CDP has launched the CDP Water Disclosure and more than 470 institutional investors representing in excess of US$50 trillion in assets supported CDP in engaging with companies worldwide to disclose and ultimately manage water issues in order to create and sustain long term shareholder value. The UN Principles for Responsible Investment was launched 2 May 2006, and was initially endorsed by international funds worth 4 trillion USD. The principles have now more than 1,100 signatories, of which more than 900 represents assets owners and investment managers.

Reforms that increase the influence of pension funds and sovereign-wealth funds, as well as increased cooperation among these funds, are important economic developments. If these funds get more influence as shareholders, they will pressure corporations to take account of their long-term social and environmental impact. This will, in turn, benefit future generations.

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