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An ESG Directive as a Driver for SRI among Swedish National Pension Funds

Abstract

This paper looks at the government directive that was issued in 2001 to prepare the Swedish national pension funds (AP funds) to take environmental and ethical considerations in their investment decisions. The open ended directive wording allowed different interpretations and consequently different choices to implement sustainable and responsible investment (SRI) strategies. The interest of SRI is growing among institutional investors and the AP funds are important actors because of the size of their combined assets and potential influence on other investors. The paper reports findings from an exploratory field study based on in-depth interviews with respondents working in four AP funds as well as their key stakeholders. The purpose of the study is to find out how AP funds interpreted the SRI directive, how strategies were implemented, and the implications for AP funds of integrating environmental, social and governance (ESG) issues in investment practice. Findings reveal that each individual AP fund assigned SRI with various degrees of priority, but eventually they all came together in a collaborative approach, the Ethical Council, to engage and influence non complying investee companies into a more sustainable practice. Outside consultants and screening companies have to various degrees advised AP funds in this process. The implication of this study is that it can give both academics and pension fund practitioners' insights in how SRI is managed and organized in practice.

Introduction

In 2001 the Swedish government issued a directive to get at national pension funds (AP funds) to consider environmental and ethical aspects in their investment practice. Eight years after the directive was launched it is time to study the outcome of the directive. This is a case study examining four Swedish national pension funds aimed at exploring how the funds interpreted the directive and implemented strategies of integrating environmental, social and governance (ESG) considerations into their investment operations.

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The paper starts with key concepts of sustainable and responsible investment (SRI) and the role of institutional investors. Then the experience from United Kingdom on a similar directive is presented before summarizing the reformed Swedish pension system and looking at the ambiguous wording of the directive. Then actual case study findings are presented before the study ends with a discussion on what implications this will have on SRI.

Sustainable and responsible investments

Sustainable and responsible investment² (SRI) involve addressing social, ethical, or environmental considerations in the selection, retention and realization of investments (Mansley, 2000, Sandberg, 2009). As publicized both in academic journals as elsewhere, SRI is becoming widely spread and recognized among institutional global investors (Avanzi, 2005; Social Investment Forum, 2008; Sparkes and Cowton, 2004; UK Social Investment Forum, 2007). According to Eurosif (2008) the market for European SRI has grown very rapidly during recent years. Many studies have focused on whether it pays to invest according to SRI criteria. Even though this issue is not addressed in this study, the performance debate is critical and to date there are a large number of academic studies evidencing mixed results (UNEP FI, 2007).

The Universal ownership concept

A growing number of institutional investors are finding SRI to be a method of their investment choice (PRI, 2008). This leads us to the well documented notion of *Universal ownership* building on the pioneer work of Clark (2000), Drucker (1991), Hawley and Williams (2000), and Monks (2001). A universal owner is a large institutional investor such as a pension fund, foundation or insurance company that serves the interest of their beneficiaries. Over the last forty years global shareholding has moved from individuals to be concentrated among major institutional investors. For example, the 100 largest fiduciary institutions in the U.S. own 52 percent of all publicly held equity (Boogle, 2005 in Hawley and Williams, 2007). These institutions are legally and morally bound to provide for the interest of their beneficiaries, Hawley and Williams (2000, p.xii) argue that managerial capitalism has been replaced by *fiduciary capitalism*. The consequence is that some of these fiduciary institutions have begun to exercise their right as “active” owners not only in the capacity of buying and selling shares. Over the past years some investors rely more on corporate governance strategies such as informal and formal engagement methods to achieve their objectives. Further, an important consequence for these large fiduciary institutions, broadly diversified and exercising index investing, is that their success is dependent on how the economy as a whole is

² Eurosif (2008) defines SRI, as a generic term covering responsible investments, socially responsible investment, sustainable investments, and any other investment process that combines investor’s financial objectives with their concerns about environmental, social and governance (ESG) issues.

performing (Hawley and Williams, 2007). The underlying notion of these authors is that universal owners' portfolio is financially hurt by environmental and social externalities such as for instance pollution and human rights violations. Thus, universal owners have an economic interest to promote sustainable practices among firms they own because in the long-run they will recognize society wide benefits from doing so (Hawley & Williams, 2000; Monks, 2001). Differently speaking, firms that make exceptional profits by passing on environment and social costs to society and the economy as a whole, are only adding short term value to a pension fund's portfolio. But seen over time, negative externalized costs are borne by all portfolio companies depressing the overall economy as well as the total portfolio value of the fund.

Fiduciary duty

Why is the role of pension fund trustees critical in exercising responsible investments? Viederman (2008) states that pension funds like other fiduciaries have "a legal responsibility to exercise reasonable care, skill, caution and loyalty to the purpose of the trust". The traditional view on fiduciary duty looked for maximizing financial returns on investments and used to *externalize* environmental, social and governance factors in the investment decisions. During the last decade we see examples of large institutional investors leaving the strict financial interpretation. A study conducted by leading international law firms emphasize that financial decisions makers acting under fiduciary obligation are required to apply environment, social and governance (ESG) considerations as part of their responsibility towards its beneficiaries (UNEP FI, 2005). What comes across as a *norm shift* consequently creates a demand for pension funds and fund managers to start to analyze the relationship between environmental, social, and corporate governance aspects and financial performance.

SRI regulations from UK and elsewhere

In July 2000 all UK public and private sector pension funds were legally required to consider socially responsible investment and voting rights as part of their Statement of Investment Principles (SIP). It is important to mention that pension funds' were not forced to invest along SRI criteria, rather take social and environmental considerations into account and to publically disclose funds' policies about this. According to Sparkes (2002, p.6), the SRI requirements would represent the first global attempt of government driven SRI requirements. The motivation for the pension regulation was an important driver for the UK SRI market to grow in size and recognition. Other contributing factors were the large number of insurance companies that applied SRI criteria to all their equity funds, as well the decision of large public pension funds, such as Hermes (Post Office) and Universities Superannuation Scheme, to adopt SRI policies (Sparkes, 2006 p.51). Even though the SIP disclosure requirements appear have had a significant impact in the UK, the investment mainstreaming of SRI as a core product has probably not yet

materialized. Sparkes (2006 p.52) suggests that even though many traditional UK fund managers brought in SRI competence, it was only on a smaller scale. UK SRI was championed by smaller financial service companies with high profile leaders successful in generating valuable media recognition and with significant retail and institutional SRI under management. A structural impediment for pension funds to introduce the idea of SRI exists as these investors many times appoint external fund managers to manage equity. The UK investment chain is complex with interconnected relationships between actors (Myers, 2004). For instance, where the asset owner might have a genuine SRI interest, the asset manager may lack the proper knowledge and incentive, evidently resulting in a case of agency predicament (Sullivan and Mackenzie, 2006 p.339).

The reforming of the Swedish pension scheme

In studies by Hess (2007) and Lydenberg (2007) references are made to SRI regulations similar to UK was seen in Belgium, Germany, Denmark, Norway and Sweden. The new Swedish pension scheme was based on an agreement between five political parties in 1999. The reasons behind the reform were low growth rates combined with increased cost of pension payments. The Swedish pension system is independent from the national budget. Current pension benefits are financed by contributions of 16% of annual pensionable income. The contributions and disbursements in the pension system change over time mainly because of changes in demographic size and salary growth. (Ministry of health and social affairs, 2000). The role of AP³ Funds 1-4 (i.e. “buffer funds”) is to cushion temporary fluctuations in contributions and disbursements. The common mission of these four AP funds is to maximize long-term return given a low risk level for the benefit of Sweden’s pensioners (First AP fund, 2008). In comparison with UK, the investment chain is less multifaceted. All AP funds manage funds internally as well utilizing external fund management resources. Consequently, as they manage funds internally they may face fewer impediments to implement SRI compared to many pension funds in the UK who rely on external managers.

During the political parties’ negotiation on the new Swedish pension scheme the issue of ethical and environmental concern was agreed upon. It appears that SRI consideration were not a controversial political issue during pension negotiations. A possible explanation is that the role of national pension funds is to manage public assets in such a way that the confidence of the general public is maintained. By combining the consideration about ethics and environment without compromising the goal of high returns the wording corresponds with general definitions on SRI (Gavelin, 2008). These considerations were passed during times of broad political support for sustainable development in Sweden. Hence, both

³ AP Funds stands for “Allmänna Pensionsfonden” and this is a collective name used to describe different national pension funds in Sweden.

environment and financial advocates accepted the broad SRI writing in the introductory work to the Public Pension Fund Act (Olivecrona, 2005). Provided is an overview of AP fund 1-4 in appendix 1.

Swedish SRI guidelines

Six months after UK implemented the SRI requirements, Sweden required its national pension funds in 2001 to consider ethics and the environment in investment decisions. Similar to the UK, the Swedish guidelines emphasized *disclosure* on how SRI considerations were actually integrated into investment management practice. As of beginning of 2001, four AP funds (1-4) were launched with the same capital base and guiding principles. The idea was that several AP funds would compete with each other and independent investment organizations would generate better yields. In the preparatory work to the Public Pension Fund Act (2000) one sentence summarizes the SRI requirement, “*Consideration shall be given to ethics and the environment without compromising the overall goal of attaining a high return.*”(Government Bill, 1999). No specific explanatory guidelines were offered. As experienced in UK, this directive was first of its kind in Sweden and the funds had little prior experience managing ESG driven investments.

Independent committee evaluation

In 2005 the Swedish Parliament Committee on Finance proposed an evaluation of the AP funds with a special focus on how the funds have lived up to their obligations of ethical and environmental considerations in the investment activities. Two years later, the Swedish trade union confederation (LO) in a letter to the Government asked for ethical guidelines and owner policies for AP funds. During 2008 a committee on ethical- and environmental responsibility of the AP funds was assigned to evaluate work accomplished so far to recommend actions for the future. The Committee evaluation report suggested that the AP funds had done satisfactory work and, that there was a need for more closely defined SRI principles and that working methods should be further improved. The Committee concluded that SRI considerations taken were not in conflict with the overall fund objective to achieve high financial returns (SOU, 2008).

Case Study Method

In this exploratory case study approach I combine data collection from several primary sources such as interviews and questionnaires, and secondary sources of academic articles, news articles, and AP fund archives. In total there are six national AP funds managing future pensions of Swedish citizens. This research study concentrates on four of these funds (AP fund 1-4) as they share the identical government mandate in original fund size, SRI guidelines and voting policies. The study involves interviews with nineteen (19) respondents representing AP fund 1-4 (Table 1). Key individuals and specialists from four

different capacities in the organizations' were interviewed. Their job responsibilities were Chief Executive Officer, Chairman of the Board of Directors, Corporate Governance/Corporate Communication (sometimes combined roles), and Investment Management. The interviews were conducted during 2007 and recorded and transcribed. Each interview lasted for approximately one hour.

INSERT TABLE 1 ABOUT HERE

In addition twenty one (21) interviews were conducted with external stakeholders operating outside the AP1-4 organization holding present or past working relationships with the AP funds (Table 1). External respondents come from stakeholder groups such as SRI consultants, rating agencies, institutional investors, government, academics, and portfolio companies. The idea of extending the interview material to also include AP fund stakeholders was based on the opportunity to receive broader opinions. The majority of interviews took place during the first half of 2008 and before the global financial crises starting in the fall of 2008. Findings that can be traced to an individual respondent are only disclosed if the information is already publically available.

As stakeholder interviews took place after interviewing the AP funds it provided an opportunity to cross-check and verify information received earlier on in the research process. The transcribed research material was coded and grouped into themes. The SRI themes that were linked to the research statement (i.e. interpretation, implementation and implications of/for SRI) were then analyzed and selected for this study. The case study approach can be criticized of extensive and time-consuming data processing which may have an impact on analysis. However, this method was preferred as it brings understanding to complex issues and accumulates experience as the number of respondents each add incremental understanding (Yin, 2003, Eisenhardt, 1989).

Case Study Findings

In this section I will highlight six themes derived from case study findings related to how AP funds interpreted the directive and moved towards shaping an organization to implement an active work process of integrating non-financial ESG factors in the investment decision. Even though a large number of themes were discovered during data analysis these groupings were believed to be essential in fulfilling the government directive. In figure 1 there is a visual overview of some typical AP fund SRI milestones between 2000 and 2008.

INSERT FIGURE 1 ABOUT HERE

SRI experience needed to interpret directive

Early on in the process of interpreting the directive, AP funds realized that external consultants were needed as internal experience and resources working with SRI were lacking (Corporate governance officer). Actually, first out to interpret the directive was the Seventh National Pension Fund⁴ (AP7). Their interpretation of ethics and the environment equaled the beliefs of the Swedish Government. This meant that international environmental, social or human conventions and treaties signed by the Government would also be endorsed by the fund. Consequently, any Swedish or foreign company in conflict with any major international conventions would at the same time violate the ownership policy of AP7. To reach this interpretation, transparent with the view of the Swedish government, an external consultant with experience from the public sector and corporate responsibility proved instrumental (CEO, Chairman, SRI consultants [3 respondents]).

AP fund respondents confirm that AP7 was first out with its interpretation of the SRI directive. The interpretation to seek transparency with the Swedish Government on international conventions like UN's Global Compact, ILO conventions and OECD's guidelines for multinational companies among other relevant conventions was later also adopted by each of the four "buffer funds". Direct discussions were undertaken with AP7 by one of the four AP funds as part of an orientation process to establish its fund policy (Corporate governance officer). Besides AP7 some respondents also mention The Norwegian Government Pension Fund - Global and the British fund manager Hermes as useful sources of reference during this process (CEO & Chairman). In the new pension scheme government was looking to stimulate pension funds to compete by splitting them into four equally size AP funds. Respondents acknowledge the competitive element between funds as central which also supports the fact that each AP fund addressed the SRI directive individually independent of AP7 from the start (SRI consultant). The length of each funds interpretation process varied and the formation of fund policies suggest shaping under the auspices of some degree of external consultation.

⁴ This pension fund is responsible for the premium pension system. In the Swedish pension system some of the pensionable incomes (2.5%) are earmarked for premium pensions. These are managed in mutual funds according to the choice of the pension beneficiary. AP7 shares the same undertakings regarding ethics and environment as the other four AP funds except that they are prohibited from exercising their voting rights in Swedish holdings. This is also the reason for not including AP7 in this study as they share a slightly different governmental mandate than the other AP funds.

Eventually AP fund 1-4 all adopted an approach which sought to engage and dialogue with portfolio companies that breach or violate international conventions. All AP fund respondents believe that it is better to influence companies into more sustainable practices as active shareholders. Exit or divestment is only an option if company's response is unsatisfactory or none existing. However, two types of interpretations are found in the interview material to explain why AP fund 1-4 advocate a strong engagement approach rather than exit or selling. On the one hand respondents refer to dialogue as a preferred moral form of active ownership. On the other hand some respondents express that engagement is preferred because exit could potentially harm the investment universe and potentially impinge on the overall goal of achieving a high return (CEO).

“In practice first it sounds like it [the Directive] must not cost anything, and therefore we can never do anything. But this is really not the case. This clever formulation gives us advantages when we visit a company and let them know that this [their practice] is not long-term sustainable. You risk your good name and reputation and at the same time we risk owners' equity. It is actually a very clever wording”.
(Chairman)

Porter and Kramer (2006) are critical to the proliferation of CSR reports, ratings and rankings. They argue that CSR has become an inescapable priority for business leaders in many countries they argue. The authors believe in CSR but not in how many companies have approached the subject. Consequently, to understand the issues business leaders have turned to a growing collection of consulting firms. Porter and van der Linde (1995) suggest that environmental strategies must become a general management issue and not the responsibility of outside consultants if ever proposed and implemented. Findings show that all AP funds to various degrees initially depended on external experts as in-house competence were building up.

Norm-based screening of all portfolio holdings

All four AP funds decided early on that it was not economically feasible to do ethical and environmental screening in-house. Respondents indicate to be a more cost effective solution to purchase these services from outside specialists. The cost aspect appears critical for all AP funds' respondents as the government performs annual audits on the organization. At the time around year 2000, two companies in Sweden offered SRI screening and analysis services to institutional investors, banks and mutual funds. Respondents recall AP funds were solicited by similar service providers located in the United Kingdom, Switzerland and United States.

The Swedish screening companies had both launched their norm-based screening⁵ towards the end of 1999. Both companies' product offering was recently developed and these firms were naturally anxious to attract a high profile customer, like an AP fund, lending legitimacy to the business and help develop the product further. Both SRI providers were linked to worldwide networks so that they could offer a global screening required by AP funds holding shares in approximately 3,500 companies. Willingness to pay for SRI screening services during early years was quite low (SRI consultants [2]). It appeared these SRI screening firms early on were financially pressured to bring in customers and fit them in current product portfolio. Respondents representing two AP funds indicate that product quality on some early reports were uneven (Corporate governance officers [2]). This was a possible consequence of a business under development with initially low profit margins and in some instances suffering from retaining employees. As these specialized consultants became more experienced they became attractive recruitments for the financial sector, naturally leaving important gaps to fill (SRI consultant).

“Our general assessment here at the fund is that the [SRI rating] industry have matured and improved, it now has a better process and they have better understood what customers require and also what is more relevant to look at”. (Investment manager)

Eventually product quality improved and customer satisfaction enhanced. The four AP funds each sought individual solutions to utilize external support for SRI screening. AP1 rendered services from a Swedish screening company. AP2 hired a consultant on long-term basis to do SRI screening on Swedish holdings and AP3 sought at one point in time advice from the UK. Finally, AP4 did not acquire screening services at all during the first years. Typical work processes for most AP funds were to collaborate with a screening company which was hired to screen the equity portfolio twice a year. Screening is a systematical process where a fund's national and global holdings are checked against not only media databases but also search engines linked with sources specialized to follow environment and human rights issues (SRI analyst). Between these formalized reports the external SRI partner issues alerts or warnings about social, ethical, environmental misconducts taking place in any of the portfolio companies.

The SRI firm that helped AP7 pioneer their norm-based screening ended up not being selected by any of the four AP funds (SRI consultant). A probable answer is that the early “AP7-model” did not appeal to AP 1-4 as it advocated “exit” rather than “engagement”. However, findings show that there are a number of additional factors explaining the different SRI approach between AP7 and the other AP funds which will be addressed in a separate study.

⁵ According to Ethixs SRI Advisors this is an analysis method of corporate activity that violates or threatens to violate global standards on environmental protection, human rights, labour standards, and anti-corruption as put forward in international initiatives and guidelines. (www.ethics.se/methodology_page1.pdf)

Engagement - the method to influence corporate behavior

While most AP funds focused on forming an asset management organization, SRI had initially a lower priority in the implementation of the new pension scheme around 2001. Even though AP funds developed policy documents addressing ethics and environment from a responsible investor perspective, each AP fund took different amount of time to actually commit to a working process for SRI. Respondents describing the SRI organization return to the fact that the responsibility only rested on few individuals. In all AP funds a specialized group was organized to handle SRI issues and they met on a semi regular basis. Internally the group is referred to either “ethical committee” or “corporate governance group”. Group members usually include CEO, corporate governance officer/communication director, or a representative from investment management side. During ethical committee meetings the selection and administration of company dialogues were discussed. The selected engagement strategy depends on a number of factors; what industry the targeted company is operating in, where the company is from, and what international convention the accused company is violating (Corporate governance officers [2]).

All four AP funds have adopted engagement as the preferred corporate governance tool. If portfolio companies violate principles of international conventions such as UN Global Compact declaration and conventions, ILO core conventions, and OECD guidelines for multinational corporations, the AP funds themselves or their SRI collaborator may initiate an engagement process on behalf of the fund. This dialogue process looks different depending on Swedish companies or foreign holdings. To get the attention from upper management in Swedish listed companies is normally not that difficult, all respondents seem to agree. Swedish companies make sure to reply if any of the AP funds raise an issue or initiate a meeting mainly depending on its size, reputation, and the fact that most Swedes are beneficiaries (Corporate Governance officer).

Critical drivers for both accentuating SRI and putting a work process together were individual change agents in the AP organization and at times aided by outside consultants. In the forming of a work process these individuals appeared to have had a catalytic effect as they influence others in the organization and drive the development process with personal engagement and interest. In AP1 and AP2 key individuals entered the organization in 2002 and 2004 respectively with some prior SRI experience. This facilitated implementation of a work process but perhaps the most important was the ability to place SRI considerations on to the executive management agenda (SRI consultant).

The corporate sustainability literature indicates that social and environmental concerns should be integrated in all areas of the organization. It is recommended for the senior sustainability officer to have access to both the board of directors and the CEO and foremost not be placed as a legal function in the organization chart (Epstein, 2008, p.102). However, critical voices say that these change agents for

sustainability operate as isolated islands lacking the ‘green’ leadership from the top (Welford, 1997, p.90, Sandberg, 2002, p.71). A central task of the CEO and senior management is to support these agents and ensure that sustainability strategies are a fundamental part of business strategy and contributing to future business success (Dunphy et al., 2007).

Reasons for engaging with Swedish companies could come from negative media exposure or a non-government organization (NGO) that published information connecting the Swedish company with violations of international conventions or principles. In this process, the AP funds seek additional answers to information normally available in annual and corporate governance reports or any other policy documents or ESG information posted on the web. To gain more specific information, the funds started to ask for separate company meetings with an ESG focus. The traditional way was for the AP fund corporate governance officer to join investment managers and analysts during regular company meetings. The focus of these meetings is pure financial, but offered opportunities to raise ESG questions as well. From the investee company side these meetings are usually attended by the Chief executive officer (CEO), Chief financial officer (CFO) and Investor Relations (IR). In some cases also the environmental manager or corporate social responsibility (CSR) manager would attend.

Respondents working with ESG issues claimed the traditional meetings to be less productive because the focus of the meeting and the mindset of responding executives are mainly financial. To circumvent this situation the governance officers of most AP funds express a preference for separate meetings with investee companies’ ESG manager. This person may at times be accompanied by either the CEO or IR. Less frequently but occurring investment managers from AP funds accompany and they see these separate ESG meetings as quite educational. They tap into a new information channel describing the company and its products. To have a company described from an ESG viewpoint make participating investment managers quite enthusiastic respondents from both corporate governance and investment management confirm.

“Portfolio managers felt it was very interesting to accompany on these [ESG] meetings...by looking at the company from a sustainability perspective you almost get a better view of the company...only to have the production unit described in other terms...this is something analysts and portfolio managers are unaccustomed to.”
(Corporate Governance officer)

Collaboration in foreign engagements

At the end of 2006 the four AP funds decided to jointly monitor environmental and ethical compliance and establishing the *Ethical Council*. The main advantages for participating AP funds are increased asset size

and additional pressure in the collective foreign engagement processes. The collaboration also brings down costs and resources devoted to this area. The Ethical Council, where its members all have confined to UN Principles of Responsible Investing, has created a systematic work process for screening, analysis and engagement. The Swedish rating agency GES Investment Services was given the contract to operationally assist the AP funds after winning an international procurement process (Ethical Council, 2008).

Each AP fund has a member representative in the Council. The overall objective is to jointly have a sustainable influence in foreign holdings connected with clear violations of international environmental and human rights conventions. In total, the four funds own shares in approximately 3.500 foreign companies systematically screened by GES. Out of these companies about one hundred are associated with some type of international convention infringement. Among these a list of 20-25 companies with documented problems are generated. Finally the Council based on GES recommendations selects 10-15 companies each year to engage with (Ethical Council, 2008). It is not required that all four funds own shares to become an active engagement member. As long as at least one AP fund is an owner the others join and act as one voice (Corporate governance officer). If the engagement process does result in a company response or an improvement, a decision to divest a holding is not collectively formed but for each individual AP fund to act upon.

Upon an incident in a portfolio company the Ethical Council initiates a direct dialog with the company. In practice the Council receives a lot of operational support from GES which hosts a secretariat with staff acting on behalf of the four funds. Other ways of influencing portfolio companies in default would be through collaborating with other investors or exercising voting rights at the companies' Annual General Meeting.

“My own reflection is that we want the same thing and by pooling resources we receive much more. [...] For the same amount of money I believe we receive more outcomes and also the fact that we are four organizations working together. One can already see that companies we tried to engage with by ourselves without any results. Suddenly, they receive a letter from Ethical Council and the CEO decides to call us!”
(Corporate governance officer)

We have seen that the AP funds in the beginning tried to interpret the directive individually without any formal collaboration between funds, but eventually after six years they joined efforts. This pattern resembles the model Abernathy and Utterback (in Klepper, 1997) developed on organizational aspects of industry evolution. In the early, *'fluid' period* of development the market needs are not well defined and different approaches to satisfy the market is seen. Innovation is relatively rapid and fundamental. But as the industry life cycle develops technological diversity is substituted by standardization. Production

volumes increase and processes are more clearly defined. Resemblance of industrial life cycle is suggested to explain the development of implementing the directive among AP funds.

ESG integration in investment practice

Findings from recent studies and surveys show that financial analysts' and portfolio managers' attitudes towards the benefits of integrating non-financial issues in the financial analysis show skepticism (ECCE, 2007; Guyatt, 2005, Solomon & Solomon, 2006). In an interview study of mainstream financial analysts it was examined to what extent they considered social, environmental, and ethical (SEE) information important to their work. The study show that respondents are aware of SEE aspects of business but do not view these indicators in company valuation (Hummels and Wood, 2005). The same survey finding indicates that there are no commonly accepted methods known to quantify ESG information and translate this into a corporate valuation model.

In the AP fund study most respondents state that the attitude towards SRI among analysts and portfolio managers have become more positive compared to when the new pension scheme began in 2001. Respondents indicate that SRI is a timely subject and that globalization and climate crises are important aspects in people's mindset today unlike a few years back (CEO & Chairman). The more analysts and portfolio managers are exposed the more they will start to learn about ESG-factors respondents say. However, in the majority of AP funds there is still unlikely that these groups actively involve ESG data in the analysis and investment process (CEO, Corporate governance official). One chief executive officer express a stronger commitment for ESG information among analysts and portfolio managers but exactly how to go about interpreting is still too early to decide. However, the general feeling among AP funds is that financial analysts and portfolio managers are today more understanding towards SRI.

“ If you put together ten portfolio managers and had them discuss Volvo, I would not be convinced that during the first hour environment and ethics would be discussed. Have I said that they ignore these issues? No, but these issues are placed further down the list of priorities, but they are on the list and that I believe is the point ”. (CEO)

The literature on organizational change and especially the “greening” of organizations suggest that this does not occur instantaneously for all employees. It is reported that some will be reluctant to new ideas and processes while others act as “environmental entrepreneurs” (Söderbaum, 2000). Another explanation is that human nature are reluctant to face changes which cause inconvenience as it involves the effort of learning a new method or procedure (Caruth et al., 1985). Hindrance to organizational learning and change are overcoming complex web of old political power bases that have been implanted and maintained by cultural norms (West, 1994). AP fund are not alone in this respect as many work places are

“structured encourage the assimilation of behavior and practices deeply embedded in past experience and reinforced resistance to change” (Gardiner and Whiting, 1997).

Unlike other AP funds, AP2 has since 2005 integrated non financial principles such as environment, social, and governance factors in an investment methodology referred as the Corporate Governance Log. This Log is limited to Swedish investments as it requires more resources and has a higher risk profile (Corporate governance official). The starting point is ten governance principles in the Corporate Governance policy of AP2. Based on company non-financial information and company dialogues AP2 evaluates companies ESG performance against policy principles. Companies are then rated based on a three-color “traffic light” system. A green light means everything is in order. A red light, in principle indicates that the fund should divest of its holding. A company with a yellow light can be a potential investment candidate. Yellow means an opportunity to change a company’s behavior through shareholder engagement and thereby create added value. As mentioned earlier, AP2 hired a SRI specialist to dialog and rate ESG risk and opportunities in twenty or so Swedish companies included in the Corporate Governance Log (Second national AP fund, 2007).

The outcome of the directive

Most respondents believe that considering ethics and environment has a positive outcome in investment practice. However, no respondent was able to formulate outcome in financial terms. Outcome in this aspect is more translated into influence. All AP funds believe they have a positive effect on portfolio companies becoming more sustainable aware. Evidence of this is dialogue meetings addressing ESG issues and challenging companies to act. Respondents say that portfolio companies are using ESG feedback from AP fund dialogue meetings to improve sustainable performance and processes. Another observation on the same note is that the environmental- or CSR-manager of the portfolio company becomes internally recognized. When an AP fund in the capacity of owner asks for specific meetings on ESG issues the message to management is that ethical and environmental considerations are important governance aspects (Corporate governance officers [2]). The latter finding is confirmed by Sjöström (2008) in her study of AP fund portfolio companies and how they consider investors sending additional legitimacy to CSR issues within the corporate organization.

SRI Implications

In this final section of the paper I would summarize how the National Pension Funds have interpreted the government directive and how they have implemented actions to comply with the SRI directive. In figure 2, I have visualized how six themes with corresponding empirical findings eventually turn into implications for the Swedish pension funds. Most of these issues will continue to develop as SRI becomes

more recognized by practitioners and some areas may hopefully be of interest for further academic research.

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SRI training and education

The fact that all AP funds at different point in time brought in SRI specialists to orient and guide them on how to interpret the SRI directive makes these organizations naturally vulnerable. I believe it is quite legitimate to bring in outside consultation in areas where the organization hardly can be expected to have acquired SRI knowledge. This also raises the need of strengthening SRI knowledge on a broader level within pension funds. Especially since findings show that SRI competence sits with very few persons in the organizations.

Screening services

Early on AP fund realized the need for outside company SRI screening. At this point in time the market for these services in Sweden was under development and the customer demand was slowly growing. Lack of norms for screening services existed and this is the industry still accused of. We have seen that individual AP funds adopted systematic company screening at different point in time as well as user critique regarding quality was noted. The implications are that specialized screening companies are needed to provide pension funds with this service as the service is specialized, complex and resource intensive. These services must have a global reach and customers like pension funds will most probably also need assistance with engagement activities. Customers like the AP funds cannot outsource everything and must obtain SRI knowhow to be able to understand the consequences of purchased data.

Engagement

Engagement has become the principle method for National Pension Funds (AP1-4) in order to influence portfolio companies to become more sustainable in their practice. The study shows that this area is time consuming and resource intensive. The implications for SRI is that engagement is a growing area which would benefit from further research as applied methods and best practice studies hardly exist.

Collaboration

Eight years after the new pension scheme was launched all four AP funds commit to internal SRI processes. Another example, the creation of *Ethical Council*, is a joint collaboration between the four AP

funds on all foreign holdings. With a combined fund size of more than 90 billion Euro *Ethical Council* represent wealth that place them sixth among Europe's largest pension funds and top twelve globally (Pension Funds Online, 2009). It is with its size and reputation AP funds hope to influence in the engagement process. This cooperation seemed as a logic and cost effective cause of action but would probably have been less fruitful unless each fund independently gained their own experience to start with. In September 2008 the recommendation of *Ethical Council* to sell holdings in nine global companies involved in market cluster munitions was followed by all four AP funds. Historically, up to this point the four AP funds had collectively only excluded seven companies. The implication is that collaboration is logic and a cost effective approach for managing engagement processes in foreign equity ownership. Needless to say common performance indicators to determine on-going engagements outcomes are probably needed as some critiques regard these process as slow and at times ineffective.

ESG integration

External factors such as climate change, globalization, and global outrage on executive compensation have put more emphasize on environmental, social and governance issues. All corporate governance officers responsible for SRI issues are now permanent members of the AP funds' management team, which was not the case when the directive was issued. The SRI acceptance among investment managers in the AP funds seem to depend largely on the degree of upper management backing and involvement. A finding which correlates with studies looking at "greening" of corporations. Hence, in terms of organizational learning, should pension funds bring in an "outside" change agent or assign someone with the responsibility from inside the organization? This study provided evidence of pension funds considering both options. The question remains, how to change the mind set of financial analysts and investment managers sometimes accused of personally incentivized on short-term acting? Training and education is suggested the proper tool for increasing use of ESG information in company valuation and investment from the UK experience (Myners, 2004; Guyatt, 2005). With one AP fund (AP2) forming investment decisions based partly on integrated ESG information for one of their managed funds, the implications for SRI are important as both methodology and outcome ought to be studied and documented for other investment managers to learn from.

Outcome

Even though respondents in this study cannot see a tangible financial performance outcome from applied SRI activities the effects are still considered positive and indirect. The study reveals that AP funds influence mainly Swedish holdings to improve sustainable processes as well as granting legitimacy to responsible individuals inside portfolio companies managing SRI. The main observed direct contribution of AP fund is reducing reputational risk, mainly environmental and social, among portfolio companies.

These implications for SRI in Sweden must be credited the government directive and the signal value of AP funds is high. In the future there must be better performance indicators developed helping us understand the outcome of engagement and SRI.

Tables & Figures:

Table 1: List of interviewed participants

Figure 1: Swedish AP fund SRI milestone activity 2000-2008

Figure 2: SRI implications for Swedish National Pension Funds

Table 1: List of interviewed participants

Type of job responsibility	Type of organization(s)	No of respondents
Chairman of Board of Directors	AP fund	4
Chief Executive Officer	AP fund	5
Corporate Governance Officer	AP fund	6
Investment management	AP fund	5
Fund administration	AP fund	3
SRI consultant	SRI consulting firm	5
SRI analyst	Screening company / Bank	5
Corporate ESG Manager	Portfolio company	2
Owner representative	Government	2
Financial Manager	Institutional investor	1
Investment Manager	Fund company	1
Researcher	Academic	1

Figure 1: Swedish AP fund SRI milestone activity 2000-2008

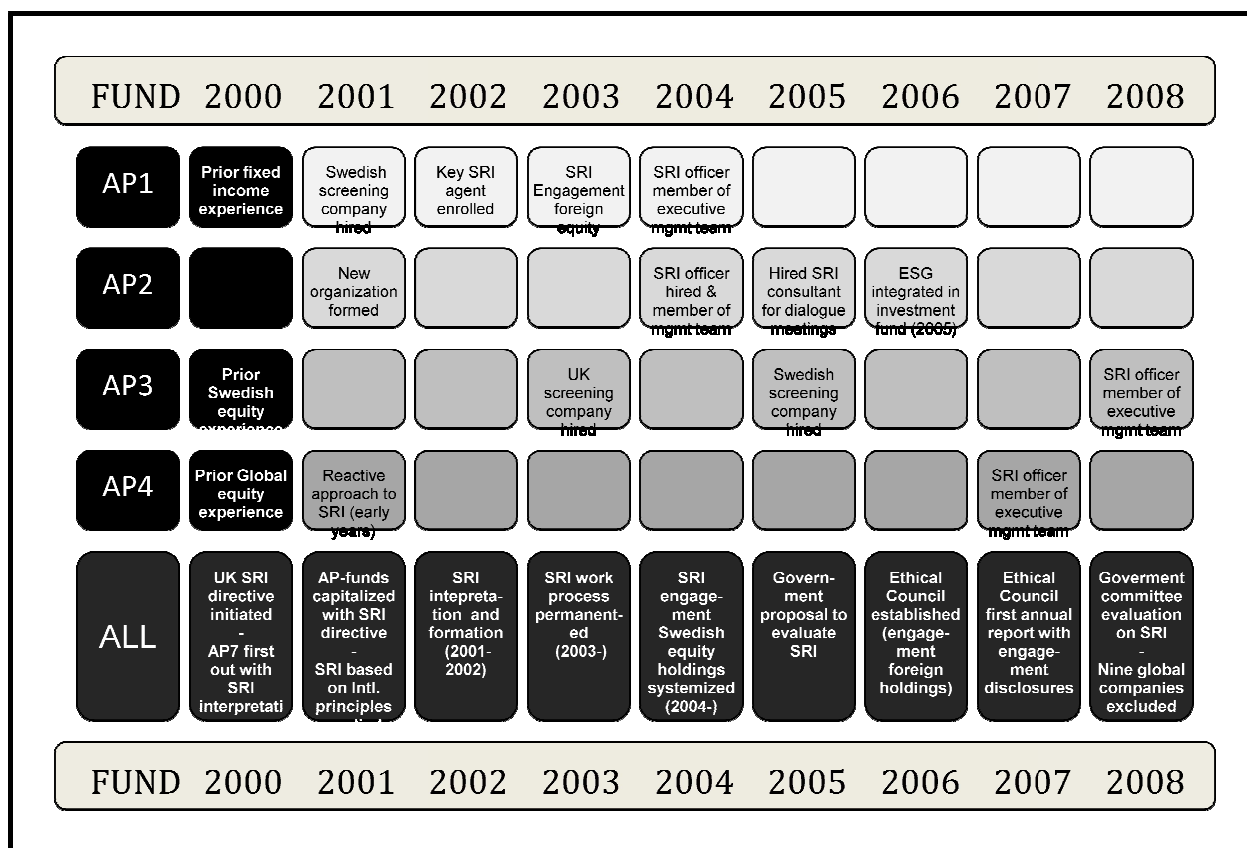


Figure 2. SRI implications for Swedish National Pension Funds (Figure to be constructed).

Theme	Findings	SRI implication for National Pension Funds
<i>SRI training and education</i>	<ul style="list-style-type: none"> - lack of internal competence and resources in 2001 - AP7 offered guidance with its adoption of norm based screening - Each AP-fund show individual interpretation process 	<ul style="list-style-type: none"> -S/T: Need for external SRI competence as in-house knowledge is building -L/T: Pension funds must emphasize continued SRI education
<i>Screening services</i>	<ul style="list-style-type: none"> - AP funds have no internal screening competence - believed more cost effective to buy service from outside providers - the quality of screening services has improved 	<ul style="list-style-type: none"> -Specialized screening companies with global reach needed to deliver SRI data. Pension funds must be able to analyze and understand delivered data
<i>Engagement</i>	<ul style="list-style-type: none"> - issue has to sit with CEO who is part of “ethical committee” - screening for violations of international conventions - seek dialogue and try to influence company to improve - divestment the final solution to no response 	<ul style="list-style-type: none"> -Engagement has become the mainstream approach for responsible pension funds and -Need for future studies on applied methods and outcome
<i>Collaboration</i>	<ul style="list-style-type: none"> - Ethical Council for joint engagement in foreign holdings - increase asset size and pressure in engagement process - cost savings being a driver 	<ul style="list-style-type: none"> -Ethical Council an attractive partner for other collaborative initiatives -An interesting model for other institutional investors to follow
<i>ESG integration</i>	<ul style="list-style-type: none"> - not yet mainstream practice among AP-funds - growing interest for SRI - AP2 applies ESG integration in investment practice - ESG dialogue in Swedish companies add interesting knowledge investors believe 	<ul style="list-style-type: none"> -Opportunity for AP2 to conduct a research study both on methodology and performance based on ESG integration in their investment practice
<i>Outcome</i>	<ul style="list-style-type: none"> - no evidence of financial outcome of SRI practice reported - influence sustainable practices and processes in portfolio companies - grant legitimacy to SRI personnel inside portfolio companies 	<ul style="list-style-type: none"> -Main pension fund contribution to SRI is so far seen in the area of preventing reputational risk among portfolio companies

Appendix 1: Fund specific overview AP fund 1-4 (31 December, 2007)

	First AP-Fund	Second AP-Fund	Third AP-Fund	Fourth AP-Fund
Fund capital 1 January 2001, Euro Bn*	13.2	13.2	13.2	13.2
Total asset under management , Euro Bn* (per 31 Dec 2007)	21.5	22.3	22.1	20.4
Average annual return 2001-2007 (before expenses)	7.26 %	7.85 %	7.68 %	6.43 %
Five year return on total portfolio after commission and operation expenses				
2007	4.6 %	4.0 %	5.0 %	2.4 %
2006	9.6 %	12.8 %	9.5 %	10.4 %
2005	17.4 %	18.5 %	17.7 %	16.8 %
2004	11.2 %	11.4 %	11.2 %	10.5 %
2003	16.3 %	17.7 %	16.2 %	16.8 %
Asset class, Percent (per 31 Dec 2007)				
Global equities developed markets	40 %	35 %	42 %	38 %
Swedish equities	13 %	20 %	11 %	19 %
Global equities, emerging markets	6 %	5 %		3 %
Fixed income	39 %	36 %	41 %	37 %
Alternative investments	3 %	4 %	7 %	3 %
External management of total portfolio (31 Dec 2007)	36.0 %	24.0 %	39.9 %	17.8 %
Active management of total portfolio (31 Dec 2007)	97.5 %	92.0 %	n/a	94.0 %
Reference made to SRI policy	Ownership policy	Corporate governance policy	Global corporate governance policy	Owner policy (Swedish only)
Total document length (word count)	2900	4200	1200	2000
Exclusions (Not excluded anymore)	Singapore Technologies (SAS) (Honeywell Intl) (General Dynamics) (Chartered Semi-Conductors)	Singapore Technologies Wal-Mart (Lundin Petroleum)	Singapore Technologies	Singapore Technologies
No of employees (per 31 Dec 2007)	64	49	51	45

Source: Annual Reports 2007, AP1-AP4., *Euro/SEK 10,18 (1 September, 2009)

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