Two different paths to sustainability?

- A comparison of a Finnish and a Swedish public pension reserve fund

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Abstract

The role played by finance in allocating resources has become crucial in modern economies. Responsible Investing, i.e., the integration of non-financial criteria (such as ESG (environmental, social, and governance), negative/positive screening, and active ownership) into the investment process, has gained an important role. Does this apply to pension funds, too? This article compares two public pension reserve funds, one from Finland and one from Sweden, and describes their path towards responsible investments. The article shows that although having taken different paths, responsible investing has been clearly integrated into the investment process of both funds during the last decades. In Finland, the role played by pension fund insiders has been remarkable. In Sweden, legislators have played an active and significant role in the process. The design of the pension system equally plays an important role in the overall process. In Sweden, cooperation is promoted in responsible investments. In Finland, pension system design fosters competition, thereby reducing cooperation in investments. This article adds more information on the scarce comparative research on public pension reserve funds.

1. Introduction

The role played by finance in allocating resources has become crucial in modern economies. In recent decades, non-financial concerns have gained importance in investment decisions. The aim of this comparative article is to investigate different paths to responsible investment policies. We study two public pension funds: (1) Keva, a Finnish pension fund of the public-sector pension scheme; and (2) fjärde AP-fonden (or, as typically abbreviated, AP4[1]), a Swedish pension reserve fund of the general pension scheme. The funds were selected based on the typical case-study method (Seawright and Gerring, 2008: 299-300). Keva and AP4 are both reserve funds and their sizes, measured as assets under management, are relatively equal. Both funds are a representative case of a fund operating in the public pension system of each country.

The guiding idea, which has led the research, was to investigate the role of institutions and, more precisely, their roles in the development of sustainable investments of public pension reserve funds (PRFs). The article adds more information on the scarce comparative research on public pension reserve funds, which are colloquially known as 'buffer funds'. As a rule, unlike private pension providers, PRFs do not fall under either the Institutions for Occupational Retirement Provision (IORP) II or Solvency II directives of the European Union (EU). Instead, PRFs are regulated by national legislation.[2]

Pension funds are large investors who, according to the financial logic, primarily seek the highest returns on their investments. In recent decades, the financial logic has been complemented by an increasing

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[1] AP is shortened from allmänna pension, which would translate to 'general pension'. The complete Swedish name, fjärde allmänna pensionfonden, would literally translate to 'fourth general pension fund'

[2] It should be noted that Finnish private-sector pension providers are equally exempt from Solvency II and IORP II regulations for the statutory pension they offer. However, the private-sector funds must follow other relevant EU legislation, such as laws on competition and investments.

emphasis on the social goals of investments (Yan et al., 2019). Sandberg (2017) has argued that pension funds, due to their intergenerational nature, should take an active role in safeguarding the interests of future generations and fragile stakeholders, as they have enormous influence on societies. Because of their nature, pension funds must consider the interests of people of different ages. If a pension fund is overly short-term oriented, it may favour older beneficiaries over younger ones (Johnson and de Graaf, 2009).

One way to consider the interests of future generations is through responsible investing (RI). Typically, RI is understood as an approach in which criteria other than directly financial ones are integrated into the investment process (Sandberg et al., 2009: 153). Nowadays, it is widely understood that these non-financial factors can influence the long-term profit-making potential of firms. RI is a phenomenon that takes a different shape across countries and jurisdictions. In the case of public pension funds, the most important non-financial factors integrated into the investment process are domestic ones. It is pertinent to study large public pension funds because public pension funds have been found to be most likely to engage in responsible investment, while larger funds (measured byassets, staff, and participants) more often have responsible investment strategies in comparison with smaller ones (Sievänen et al., 2012). Public pension funds have a long history in RI: their managers were among the first to apply ESG (environmental, social, and governance) screening on investment choices (Munnell and Sundén, 2005).

The countries for this article were chosen because they provide for a good comparative setting: in Sweden, the practice of responsible investment is more established than in Finland, where it has become more common only in the last decades. Scholtens and Sievänen (2013: 609) point out that socially responsible investments (SRIs) started in Sweden in the 1960s, but Finland saw its first SRI activity in 1999. Therefore, compared with Sweden, Finland does not have a long tradition in the field of responsible investments. The methodological approach is that of a qualitative comparative case study. Most of the data were gathered from previous studies and publicly available information. In addition, two interviews were conducted with a representative working with responsible investments in each Keva in Finland and AP4 in Sweden.

Public pension reserve funds and responsible investments

Our approach is institutionalist. Following Hall and Soskice (2001), we understand that institutional structures condition investment strategies. Many institutional factors that condition the behaviour of PRFs remain nation-specific. Therefore, we find a comparative approach salient for our study. Our unit of analysis is at the level of pension funds, but we equally pay attention to the political and legal environment, which is different in Finland and Sweden. Sievänen (2013) argues that responsible investment should be examined at the level of pension funds, as neither the macro-level (culture, economy) nor the micro-level (values, beliefs) cannot provide for an adequate answer to the question on what drives their responsible investments.

Equally, we apply the principal agent theory. According to this theory, employees of public pension reserve funds are agents who should act according to the interests of the principals, i.e., the current and future beneficiaries of the fund. In brief, the theory explains the problems of a situation in which one actor (the agent) acts on behalf of or in the name of another actor (the principal). Principals want to make sure that agents' interests align with their own. This is done by creating incentives or rules or by monitoring (Shapiro, 2005).

Both Keva and AP4 are public pension reserve funds. Their legal nature differs from private funds, in that they do not have a solvency framework to follow. Yet, by rule, their assets cannot be used for anything other than to finance public pensions. However, due to their place within the public domain, public reserve funds are at risk of unpredictable political interference. Governments can modify the relevant legislation and tap into the funds to finance current government spending instead of future pension benefits (for an overview of recent cases, see Casey, 2014).

The OECD (2018) has defined pension reserve funds that are "set up by governments or social security institutions with the objective of contributing to finance the relevant pay-as-you-go pension plans" as sovereign and public. Both funds under scrutiny fall under this definition: the Swedish AP4 finances the general pension scheme, while the Finnish Keva finances the statutory local government pension scheme. Both schemes operate, as public pension schemes typically do, on a pay-as-you-go (PAYG) basis. In a PAYG scheme, current retirement benefits are financed directly by contributions levied from current workers.

The relevant stakeholder groups for PRFs are the plan participants, the government, asset managers, and taxpayers. The plan participants (current and former) are interested in the performance of the scheme, while the government is interested in the costs and, occasionally, the investment policies of the system. Ultimately, though, taxpayers bear the final risk related to financing if the pension system has any benefit-level guarantees (Mitchell, 2002). Yet, the asset managers play an enormous role, as they make the individual decisions on investments.

The two funds differ in what we understand by the term 'public'. AP4 is a reserve fund to the general (public) pension scheme. Keva is public in the sense that it manages the pension assets of local government employees and pays out the pensions of any employee working in the public sector. As we understand that the pension 'ecosystem'[3] is important in defining pension policies, we will briefly describe the pension systems of the two countries (Table 1). Keva is a bigger fund by the size of assets under management and the number of staff. Yet, the number of staff working in responsible investments is only one-quarter of that in AP4. This is due to Keva's role as a pension provider, whereas AP4 only manages assets without any customer contact.[4] The shares of fixed-income and equities are relatively close in both funds. As the shares of contributions, workforce, pension benefits, and pension recipients show, both pension funds play an important role in the statutory pension system. Between 2011 and 2020, the average real return on

[3] By ecosystem, we mean the different roles given to institution sand stakeholders in a given pension system, in addition to the legislative framework.

[4] For example, Keva is responsible for making decisions on rehabilitation and disability benefits, paying out pension benefits, and communicating with customers on pension applications.

investments was relatively higher for AP4 (8.6%) compared with Keva (4.8%;Table 2). Both funds employ a variety of responsible investment policies and, on paper, it is hard to find a big difference between them. For exclusions, AP4 publicly discloses that it does not invest in the following products: nuclear weapons, tobacco and cannabis, cluster munitions and mines, and certain fossil-based companies that are not aligned with the Paris Agreement. In addition, it has listed 17 companies that it has excluded on the recommendation of the Council of Ethics. Keva's exclusion list covers all companies that produce controversial weapons (namely, anti-personnel landmines, cluster munitions, and chemical, biological, and nuclear weapons). Since 2021, Keva has also applied a climate-scenario analysis on its assets.

Table 1. Characteristics of the two funds

	Staff in responsible investments (out of total)	Assets under Management (in 2019)	Average real return (2011-2020)	Asset class	Share of pension contributions	Share of pension benefits
AP4	8 (of 53)	EUR39 billion	8.6 %	31 % Fixed income 56 % Equities 13 % Real assets	25 %	25 %
Keva	2 (of 501)	EUR57 billion	4.8 %	35 % Fixed income 53 % Equities 6 % Real estate 6 % Hedge funds	27 % of the workforce	36 % of pension recipients

Sources: UN PRI 2020a; UN PRI 2020b ; AP4 2019; Keva 2020 ; ETK2021a

Table 2. Responsible investment policies of the two funds

	ESG integration	Exclusion list	Screening	Climate-scenario analysis	Endorse UN sustainable development goals
AP4	Yes	Yes	Negative, positive, and norms-based	Yes	Yes

Keva	Yes	Yes	Negative and norms-based	Yes	Yes

Sources: UN PRI 2020a; UN PRI 2020b; AP4 2019; Keva 2020

2. Overview of the Finnish pension system

The Finnish pension system consists of a single, mandatory pillar with two tiers: a statutory earnings-related pension (second tier), which is complemented by a pensions-tested and residence-based national pension (first tier).[5] Due to the comprehensive coverage of the statutory systems, lack of tax incentives, and the absence of a pension ceiling (neither in income nor in pension), the significance of supplementary pensions - that is, occupational pensions (second pillar) or individual pension insurance (third pillar) - is negligible in Finland (Vidlund and Preusker, 2013).

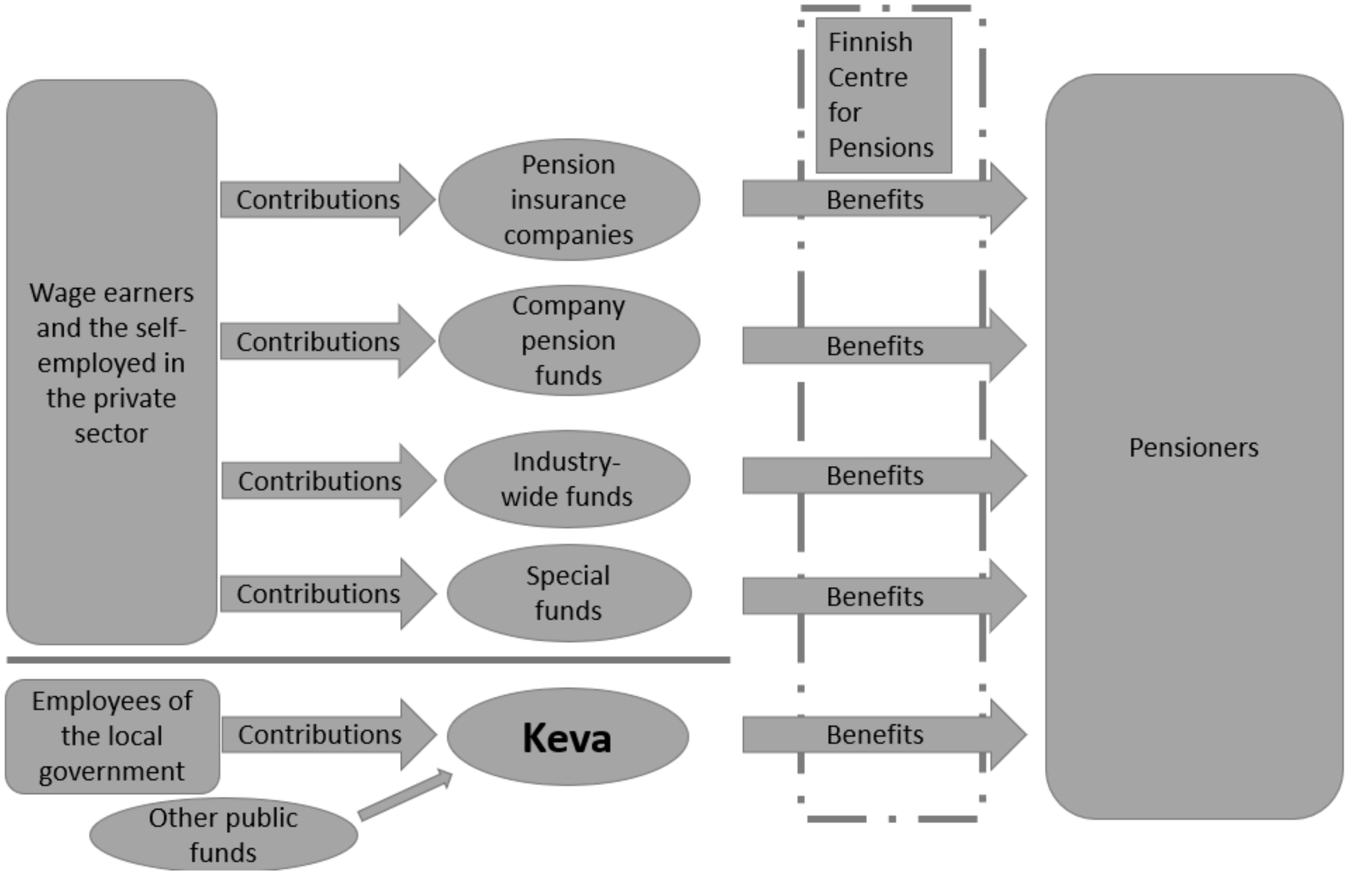
Earnings-related pensions are mostly financed by contributions and the use of funds. In 2020, the wage-based pension contribution fee for the private and public sectors was, on average, 24.4% of one's salary (ETK 2020a).[6] In the earnings-related scheme, the state takes care of the contributions for certain social security benefit recipients. The financing method is PAYG with significant partial funding (Ambachtscheer, 2013).

The management of private-sector pensions is decentralised due to the origins of the scheme: the Finnish earnings-related pensions have been partially pre-funded since the creation of the scheme in 1962 (Hannikainen and Vauhkonen, 2012: 15). These private pension providers compete against each other. However, the providers have a joint liability for all accrued pension benefits, which significantly decreases competition (Johanson and Sorsa, 2010). It is the task of the Finnish Centre for Pensions to calculate the liabilities of each pension provider regarding the pay-out of the pension benefit (ETK, 2021b). If a provider falls into bankruptcy, the other providers are liable for the accrued pensions of that provider. The Finnish pension system could be described as a semi-closed ecosystem, wherein existing providers compete over their market share and possibly merge, but it is highly unlikely that newcomers will enter the market. Since 2000, the number of pension providers has decreased from 62 to 27 (ETK, 2021c; Figure 1).

[5] Both these pension schemes are covered by the EC Regulation on the Coordination of Social Security Systems (883/2004).

[6] In addition, Keva charged 3.99% expenditure-based contributions to its members in 2020.

Figure 1. The flow of contributions in the Finnish earnings-related pension system



Source: Author's elaboration

At the beginning, part of the contributions were lent back to the employers in the form of a premium loan. This provided capital for domestic industrial production. The interest rate for these premium loans was fixed for over three decades (Sorsa, 2011: 138). Later, mainly after the opening of the Finnish financial sector in the 1980s, premium lending lost its importance. Pension providers started becoming more diversified and international (Hannikainen and Vauhkonen, 2012: 15). McCarthy et al. (2016: 7) have described the evolution of investment policies as "a shift from long-term loan provision for domestic industrial production to actively managed, internationally diversified portfolios since the late 1990s." The reforms of investment rules in 1997 and 2007 promoted an equity-driven investment policy and required extensive diversification of equity portfolios (Hannikainen and Vauhkonen, 2012: 15).

2.1 Keva – public pension reserve fund

As mentioned before, the 'principals' of Keva are the plan participants, i.e., current and future beneficiaries. Keva has two roles in the public pension system: it is the pension provider for all employees of the public sector, as it pays out pensions directly to beneficiaries, and it is the pension reserve fund of the local government. Keva was established in 1964 as a pension institution for employees in the local government (Barr, 2013). The earnings-related pension is of a defined-benefit type, and investment returns have no direct impact on the pension benefit. As accrued pension benefits are understood to be protected by the right to property, the guarantors of this promise are ultimately the taxpayers (ETK, 2021d). Keva has quite a long but rather narrow history in investments. From 1967, it offered affordable loans to municipalities. A big change in investment policy came in 1988, when it was decided that Keva would start accumulating assets for a reserve fund so it could prepare for the increasing pension expenditures of the 21 century (Blomster, 2004). The first year in which the pension expenditure was bigger than pension income was 2017. The decision to pre-fund was supported by the fact that the private-sector pension system had been partially pre-funded since the creation of the pension scheme in 1962. At the end of 2015, the financial assets held by the Finnish pension providers equalled 91% of GDP. The majority of the assets were held in the first pillar (ETK, 2020b). Keva is the biggest pension fund in Finland by the size of its assets, which amounted to almost 24% of GDP, or EUR 57 billion, at the end of 2019. The Ministry of Finance oversees the concerning legislation. The Finnish Financial Authority supervises Keva's investment policies and reports the findings to the Ministry of Finance every year.

2.2 Who decides on investments?

Keva's administrative structure is crucial in finding the locus for decisions on investment policies. As a PRF, relevant stakeholders for Keva are plan participants, (local) government, asset managers, and taxpayers. It is an independent entity with a legal personhood. It has a two-tier governance structure, which consists of a council and a board of directors (BoD). The latter is appointed by the council and is responsible for strategic decisions. Keva's board of directors consists of eleven members, of which three represent employees, two represent employers, and six represent taxpayers.[7] Those members representing taxpayers are nominated by the association of Finnish municipalities. Thus, the majority of the board are political actors representing the interests of local-level taxpayers. The task of the BoD is, among others, to approve Keva's strategy and, on a yearly basis, approve the investment plan of Keva's assets. According to the act on Keva, the BoD must approve principles of corporate governance. A yearly report must be produced on the application of these principles. Members of the BoD are given training in financial competences by Keva. As part of the training, information on responsible investment is given.

According to the website (Keva, 2020b), "Keva's council consists of 30 members. Four represent employee organisations, four employer organisations, and the rest are appointed by political parties reflecting the most recent municipal election results". The task of the council is to represent the interest of the principals. The council decides how many assets are transferred to the reserve fund. Thus, we can conclude that both the council and the BoD reflect the political composition of Finnish municipalities and the interests of municipal-level actors. Typically, the Centre Party has had the most municipal councillors in Finnish local governments. Also, the CEO of Keva has typically been closely affiliated with the Centre Party.[8]

Yet, it is up to the portfolio managers and analysts to make the individual decisions on investments. Their work should reflect the strategic decision taken by the strategic bodies. Keva uses both in-house and

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[7] In Finland, municipalities are self-governing units and they have the right to tax their residents.

[8] The Centre Party belongs to the Alliance of Liberals and Democrats for Europe (ALDE) Party. Nationally, the Centre Party is considered a party of agrarian origins and one that is positioned in the centre of the political spectrum.

external managers in investments. The principal-agent asymmetry is more present in the case of external managers, as they often incur higher costs and might have diverging motives, as acknowledged by Keva (Karhunen et al., 2017).

2.4 Finnish legislation sets few requirements

Keva's operations are based on the Public Sector Pensions Act and the Act on Keva (66/2016). No specific legislation exists on investments other than the mention in the act that Keva is a long-term investor that must ensure the safety of and return on investments. The general principle governing the investment operations of earnings-related pension providers is that pension assets must be invested profitably and prudently, taking into consideration the long-term liabilities of the fund. This applies equally to Keva, and there are no other legislative regulations regarding investments for Keva (Viherkenttä, 2020). As such, the mandate is vague and does not give any specific targets or measures against which to evaluate the fund's performance.

Finland lacks parliamentary tradition in issues related to pension policies, as reforms have typically been negotiated among the labour market parties and only approved by Parliament after the labour market parties have reached an agreement (Hannikainen and Vauhkonen, 2012). Any pension-related initiative not coming from the main decision-makers of the scheme – i.e., the labour market parties - has a typically low chance of success. In recent years, due to the political composition of Keva's administration, some politicians have occasionally proposed increasing domestic exposure of pension investments; however, these discussions have been quickly silenced by the pension industry. There has been no political debate on responsible investments of the pension funds so far.

The political agents taking part in the governance of Keva are typically municipal councillors who have entered politics to decide on local-level affairs, such as health care and culture services, as well as infrastructure. It is safe to assume that, on average, municipal councillors have a limited knowledge of issues related to responsible investments. The law does not set any requirements on financial knowledge. Neither is there any special training provided by Keva. The lack of knowledge increases the role played by the employees of Keva, who are the industry insiders, in the development of investment strategies.

The Finnish Financial Authority oversees Keva's investments. Responsible investments are based on voluntary and non-quantifiable issues; therefore, they remain largely outside the supervisor's scope. However, according to the law on Keva, every year, the BoD has to confirm the principles of corporate governance. Equally, the law requires the BoD to publicly disclose how it has implemented the corporate governance in practice and justify any possible deviations. Yet, the stipulations on corporate governance are mostly procedural, stating the principles that Keva uses for ownership steering; as such, they do not make any explicit requirements on sustainability. The corporate governance principles seek to assure Keva of returns to its investments. The exact content of the corporate governance principles remains for the BoD to decide. The Financial Authority does not supervise responsible investments, but it can give non-binding recommendations, although it has given no such recommendations so far.

In the absence of legislative acts, recommendations and principles steer investors' approach to responsible investment. In Finland, it is up to the pension provider to independently define its own investment and ownership policy; still, as aforementioned, the law on Keva sets some requirements on the procedural aspects of corporate governance. Previously, pension providers shared common guidelines on responsible investments (Tela, 2008). Savilaakso (2015) saw these guidelines, drafted by the pension fund lobby organisation Tela, as having contributed to the spread of responsible investment policies in the pensions industry. Since 2008, these guidelines have not been updated. As Sorsa and Rompaukis (2017: 176) point out, the investment rules of pension providers have been reformed on several occasions to enable investing in riskier and more profitable assets on a global scale. As pension providers compete on investment returns, this is the primary target of their investments.[9] Decreasing cooperation has led to all pension insurers having their own procedures and principles for assessing and reviewing the responsibility of investments. It could be argued that the responsible investment approach is another aspect of competition between funds in attracting customers. Therefore, the concept of responsible investment at the national level is rather vague.

However, the responsible investment strategies of private and public pension funds in Finland are rather similar and it is hard to find significant differences between them (Viherkenttä, 2020: 179). All the Finnish first-pillar pension funds are signatories to the United Nations Principles of Responsible Investments (UNPRI). Also, Keva uses the UNPRI guidelines - which it signed in 2008 – to guide its responsible investment process. The aim of the guidelines is to integrate ESG criteria into investment decision-making and ownership practice. It is still uncertain whether adherence to UNPRI guidelines is sufficient alone for achieving this. A recent study (De Groot et al., 2021) on the asset managers of PRI signatories showed they do not vote in favour of environmental and social issues any more often.

Keva cooperates with other pension providers on responsibility issues, but makes decisions on its own. Even though Keva has a unique role and task in the Finnish pension system, its investment success is most often compared to Finnish private-sector funds. Its responsible investment approach resembles that of private-sector pension providers in many ways, whose governance and investment standards are similar to those required of Keva.[10] As Ambachtscheer (2013) concludes for Sweden, we observe that in Finland, pension funds have 'herded' together with similar investment policies and hence similar investment results. This probably equally applies to responsible investment strategies, as the funds are mainly compared to each other based on returns on their investments in domestic discussions

2.5 Responsibility is on the increase?

Keva's BoD reformed its steering of investments markedly in 2017 when it approved principles on investments for the first time.[11] In the same year, principles on responsible investments were also approved. Due to the lack of regulation in sustainable investments or investments in general, the role of the BoD is very important in shaping and deciding responsible investments. According to these principles, Keva's investment strategy is to integrate a sustainability or 'ESG' approach, as this is understood to bring extra value

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[9] Pension providers can offer rebates for their customers based on their investment returns (Ambachtscheer 2013: 18).
[10] In 2019, a working group set up by the Ministry of Social Affairs and Health and Ministry of Finances proposed the merging of the local government and private-sector earnings-related pension systems for employees. Currently, a tripartite working group is implementing such a plan. The deadline set by the working group is the end of December 2021.This would mean that Keva's monopoly on local government pension insurance arrangements would be abolished.
[11] Sustainability has been part of the investment strategy since 2002 and the first corporate governance document was approved in 2003.

in the long run through higher returns and lower risk (Karhunen et al., 2017). This document, that guides portfolio managers in their operations, states that responsible investing is only possible with a long-term investment approach, as ESG risks are mostly long term.

Keva has a Responsible Investment Steering Group, which coordinates and develops responsible investing (Vidlund et al., 2015). Yet, this body is internal and does not publish its documents or meeting details. Although Keva competes over its customers only to a limited extent, peer pressure exists in the form of national-level comparisons. Nationally, Keva's investment returns and administration costs are compared to those of private-sector pension providers, and not to foreign reserve funds. Due to the size of the pensions industry, rules regarding partial funding, and the relatively small number of investment professionals in Finland, the funds closely follow each other's investment strategies and success.

Keva measures the achievement of its responsible investment targets by looking at investment returns in the long run, ameliorating the mechanisms of active ownership, measuring the environmental targets of its real estate investments, looking at the share of ESG investments in the passive portfolio, decreasing the carbon intensity of the portfolio, and enhancing the mechanisms of active ownership. Keva follows the external asset managers' voting and engagement analysis through an annual ESG questionnaire. External asset managers make more than 80% of investments in equities. The exceptions are real estate and fixed income, where staff make most of the investments (so-called 'direct investments'); yet, even then, external actors make almost 40% of investments. External asset managers are important: in equities, less than 20% of investments are made directly by Keva staff (so-called 'direct investments'). The highest shares of direct investments (without any use of external actors) are in real estate and fixed income, where the shares are over 60%. In 2018 and 2019, Keva replaced the benchmark indexes of its passive portfolios with ESG indexes. Keva does not invest in controversial weapons.

This exclusion stems from international conventions banning the use of controversial weapons. In addition, Keva sees that the UN Global Compact serves as the basis for international norms. However, Keva's aim is always first to encourage compliance with international norms influence norm violations. The recent EU taxonomy for sustainable finance will not be directly applicable to Keva and it is still unclear how the fund will follow the taxonomy approach.

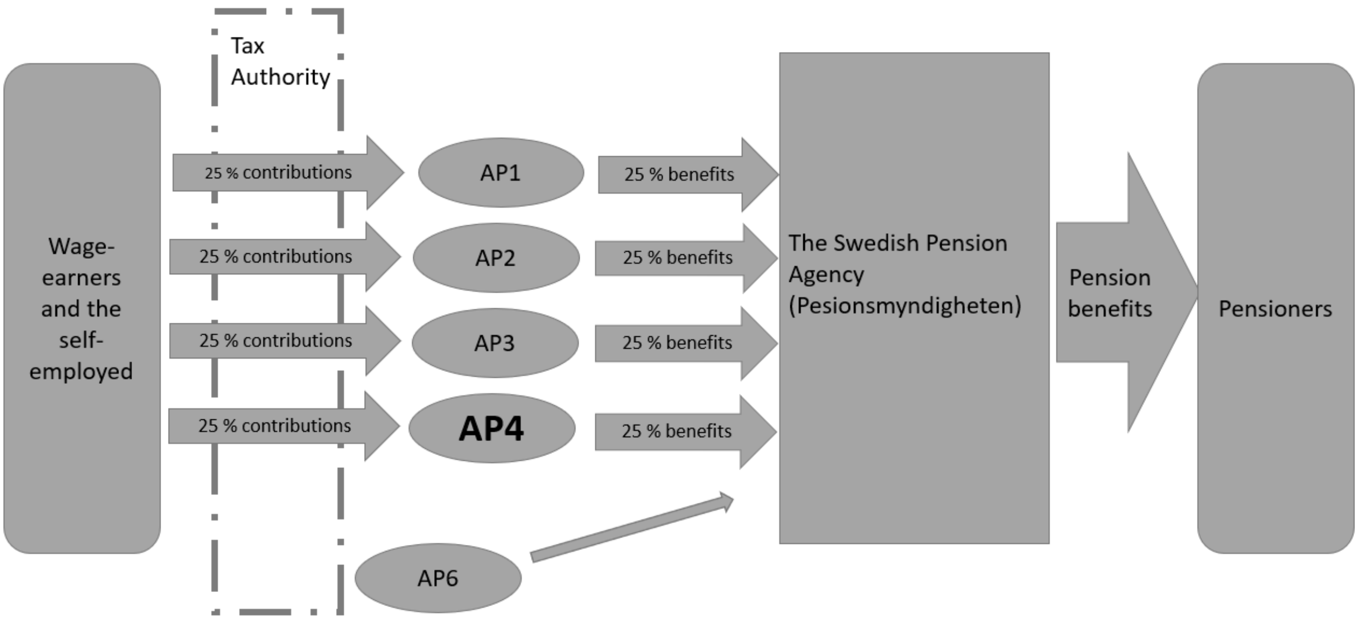
We can conclude that responsible investment has grown to be an important part of Keva's investment strategy. Yet, it remains subordinate to the main economic aim of generating safe returns on investments. Responsible investment is about improving the profit-to-risk ratio. The Finnish funds do not publicly disclose all information on investments. Keva's increasing focus on responsible investment is largely driven by industry insiders, while legislative changes and public debates are lacking. Tela, the pension fund lobby organisation, was previously a driver in the development of responsible investments; however, this is no longer the case, as competition has increased and all pension providers now have their own strategies. Keva follows international development and best practices in the field of responsible investments where it sees fit. Yet, more transparency would help in monitoring the work of 'agents' (industry insiders) in the eyes of the 'principals' (current and future beneficiaries of the fund). Another option would be to create rules designed to increase transparency.

3. Overview of the Swedish pension system

The Swedish public old-age pension system covers everyone who has worked or lived in Sweden. It consists of an earnings-related component based on notional accounts, a private, mandatory defined-contribution system (the premium pension), and an income-tested top-up (a minimum guarantee pension). The public pension system is the same for all occupational groups, the self-employed, and both private-sector and public-sector workers. On top of the public pension system, most employees are covered by occupational pension schemes (Lindquist and Wadensjö, 2011). Private, third-pillar pension savings are relatively uncommon. This might be because tax deductions for private savings were abolished in 2016.

The public pension system has amassed assets since the start-up of the pension scheme. The national reserve pension funds - the so-called 'AP funds' - were set up when the earnings-related pension tier (ATP) was created in 1960. Their role was to administer pension capital and they were initially responsible for outgoing pension payments (Hagen, 2017: 39). Today, the Swedish Pension Agency (PM) pays out the pension benefits. During the starting years of the ATP system, the contribution rate was set higher so that the system could accumulate reserves, which would mitigate the need to cyclically adjust the pension contribution rate. Another aim was to offset the decrease in private saving due to the increased capital available for lending (Sundén, 2006). AP funds are separate from the state budget and have a global portfolio. In the long run, they should cover the expected increase in pension expenditure. Historically, these funds were primarily used to finance such goods as affordable housing. Investment in equities came only later, on a relatively small scale (Anderson, 2004: 18). AP funds were created with the same starting point and same mandates. The main objective of creating these multiple pension funds was to stimulate competition between them and guarantee a better return (Björkmo and Lundbergh, 2010; Figure 2).

Figure 2. The flow of contributions in the Swedish public pension system



Source: Author's elaboration

The current structure of AP funds came about as part of a larger pension reform at the turn of the millennium. In January 2001, each of the four AP funds (1-4) received a similar amount of starting capital. At the same time, a specialised fund (AP6) was set up. The funds operate independently and autonomously from the Swedish Parliament (Langensjö, 2012). Such autonomy was one of the main goals of the legislative change in 2001 (Stalebrink, 2015). One-quarter of the social security contributions made towards the state pension system are directed by the Tax Authority into the first four AP funds. In turn, each of the four funds pays out one-quarter of the benefits due from the general pension system (Stewart, 2012).

Pension policies in Sweden are decided in Parliament by a cross-party working group, Pensionsgruppen. The topics that the pension group discuss include questions related to the pension contribution level and benefits, but also the investment regulations of AP funds. Six parties are represented in the group. Together, they have typically held a clear majority in Parliament. Thus, if they have reached a consensus, they have been able to push it through Parliament. The parties of the pensions group are the Social Democratic Party, the Moderate Party, the Centre Party, the Green Party, the Christian Democrats, and the Liberals. Of the parties present in the Swedish Parliament, the Swedish Democrats and the Left Party do not participate in the cross-party working group.

3.1 National pension funds in Sweden

Jointly, the four AP funds manage assets that amounted to roughly 32% of GDP, or EUR 154 billion, in 2019 (Swedish Government, 2020). The capital assets of AP4 amounted to some 8% of GDP, or EUR 39 billion, at the end of 2019. The AP funds are, by law, committed to providing long- term returns while also considering ethical and environmental issues in their investment choices. Their mandate is thus stricter than that of Keva, which only consists of providing long-term returns. The Swedish AP funds are legally sovereign, with their own investment and ownership policies and risk management plans. They are not under the direct steering of the Swedish government or Parliament, but they are under obligation to compile annual financial reports for the country's government. The investments are steered in acts. These acts include quantitative investment limitations and a low risk level requirement.

The role of the AP funds in the pension system is twofold. Firstly, they provide liquidity by financing pensions when incoming pension contributions do not fully cover outgoing pension benefits. Secondly, they invest any surplus that results when pension contributions exceed pension benefits, thereby strengthening the long-term financing of the pension system by generating the best possible returns on assets. The first four funds are governed by the same legislation. The four AP funds are government agencies. The Swedish government appoints their boards and auditors, approves their annual results, and evaluates their administration. AP6, a private equity specialist, is governed by its own legislation and isa closed fund. It does not receive yearly contributions nor does it have a duty to finance pension benefits (Mielonen et al., 2020).

The Swedish earnings-related pension is of a defined-contribution (DC) type; thus, the investment success of the reserve funds impacts on the level of pensions through a balance-ratio mechanism, which divides the current market value of the reserve funds plus contribution assets by a measure of pension liabilities (future pension obligations) (Barr and Diamond, 2011). The balance-ratio mechanism, colloquially known as the "brake", ensures that the system remains fiscally sustainable in the long term. The mechanism slows down indexation if the balance-ratio falls below the agreed level.[12] The brake has been activated several times; according to Stalebrink (2015), this has led to a significant increase in the interest on AP funds' activities. It feels safe to argue that the DC character of the benefit, together with the brake mechanism - which directly influences individuals' current and future benefit levels- have increased the public's interest in the AP funds' investment activities, including sustainable investments.[13] There is clearly a "skin in the game" element in the Swedish pension system, as negative returns decrease pension benefits. Conversely, the Finnish pension system is a defined-benefit (DB) scheme by design; thus, investment success has no direct impact on benefit levels. This could be one reason for the lower public interest in pension funds' investment policies in Finland - including responsible investments - as they have no impact on the benefit level.

Some studies have been critical towards the benefits of the fragmented system and whether it fosters competition, reduces the risk of political influence, or diversifies investment risk (Ambachtscheer, 2013; Björkmo and Lundbergh, 2010). Ambachstcheer (2013: 26) argues that the strategy of competing reserve funds has not achieved the goals of competition or the diversification of investment risk, as the AP fund managers have followed each other, with very similar investment policies and very similar investment results.

The boards are of an institutional type. They consist of nine members (including two representatives nominated by organisations representing employees' interests and another two representing employers' interests). The chair and vice-chair are nominated by the government. According to the law, the fund's board and operations should not be controlled by government directive or economic policy interests.

3.2 National legislation requires exemplarity

As the AP funds invest on behalf of a very heterogenous group of people – namely, current and future citizens of Sweden - they have sought to find the lowest common ethical factor that does not compromise the financial targets of the funds (Sandberg et al., 2014). As a solution, the AP funds rely on national law and international standards that set out the minimal norms by which investments are expected to abide (Hoepner and Schopohl, 2018). The national parliament is understood to be the best representative of the will of the Swedish people. The most recent legal text, valid since January 2019, states: "The four AP funds must manage their funds in an exemplary way through responsible investments and responsible ownership. When managing funds, special emphasis must be given to how sustainable development can be promoted without compromising on the overall objective regarding return and risk" (AP4, 2021). The national parliament introduced the objective for the funds to manage pensions assets in a way that contributes to sustainable development. Even though AP4's investment mandate is more strictly defined than that of Keva, it does not give any specific targets or measures against which to evaluate the fund's performance on sustainability. Richardson (2009) has proposed that investors should be legally required to meet certain sustainability benchmarks that have been set independently.

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[12] Equally, a "gas" mechanism exists, which enhances indexation if the balance-ratio goes above an agreed level.
[13] In recent years, there have been two large scandals involving fraudulent (Falcon Funds) or questionable (Allra) behaviour by pension funds in the Swedish premium pension system (Fixsen, 2020). It seems reasonable to assume that these scandals have also increased media and public interest in the investments of public pension actors.

According to legislation, the AP funds have to consider the international conventions ratified and international agreements backed by Sweden. Therefore, these international agreements and conventions serve as tools for the AP4 to interpret what 'responsibility' means to the Swedish population. Yet, this leaves discretion for the fund to do the final interpretation on how the requirements of the convention can be applied to, or integrated into, the investment process. In recent years, following internal assessment, the AP4 has decided not to invest in companies for which thermal coal or oil sands account for more than 20% of sales. This decision is based on the interpretation of the UN's Climate Convention and the Paris Agreement. Similarly, the Council of Ethics has made recommendations to divest companies that manufacture anti-personnel mines or cluster bombs, as Sweden is a signatory to the Mine Ban Treaty and the Convention on Cluster Munitions. These are clear examples on how the agreements and conventions signed by Sweden flow into the investment decisions of AP4.

As the actual interpretation of the investment mandate is left to each of the funds, Severison and Stewart (2012) have argued that investment objectives are disparate and inconsistent. The lack of distinct, specific, and long-term investment objectives that are consistent across funds has meant there are no clear and objective targets against which funds' performance can be measured (Severison and Stewart, 2012).

3.3 Cooperation to increase transparency

Since 2001, it has been a legal requirement that AP funds consider ethical and environmental aspects in investment policies (Sandberg et al., 2014). The four AP funds established a joint Council of Ethics in 2007 to coordinate the funds' sustainability work on the ethical and environmental compliance of their foreign holdings. In domestic equities, AP funds are well-known, powerful investors who alone can influence companies. AP4 is very transparent in its holdings and discloses all the listed and unlisted shares and bonds that it owns on its website every six months. It also publishes how it has voted in the Annual General Meetings of the companies that it owns. Both the work of the Council of Ethics and the public disclosure of voting behaviour provide the 'principals' with more information on the actions of 'agents'. The Council of Ethics acts by giving recommendations on exclusions and by collaborating and engaging in dialogue with companies on behalf of the AP funds. The council also publishes these recommendations, while the AP funds publish the assets they have excluded based on these recommendations. The council has been active in giving recommendations, and the AP funds have followed them. This collaboration gives the funds greater leverage in their influence efforts and increases the efficiency of their engagements with companies (Hoepner and Schopohl, 2016). Yet, the AP funds are independent when it comes to exercising their voting rights (Severison and Stewart, 2012). Whilst the Council of Ethics has contributed to the emerging sustainability discourse of investments in Sweden, it has not challenged the primary goal of economic return. Despite the increase of sustainability discourse over time in the council's reports, the other (sustainability) aspects are treated as restrictions on the primary goal of maximising economic returns (Boudin and Olsson, 2021).

The EU's impact is less clear. Current work to implement the Sustainable Finance Disclosure Regulation and EU Taxonomy Regulation will not be directly applicable to the AP Funds, but it is highly likely the funds will voluntarily follow the obligation to provide information, as required by the regulations. In the future, the funds expect that the EU will have an impact on more uniform reporting on sustainability issues. AP4 follows closely the example set by the Dutch pension funds, as these funds are considered frontrunners when it comes to responsible investments. The most recent legislation gave the Swedish AP funds more possibility to invest in illiquid and alternative assets, reduced the minimum portfolio allocation to interest-bearing securities from 30% to 20%, removed the requirement for the funds to use external managers for a proportion of their assets. The core values shared by the AP funds require them to consider openness and efficiency in their investment strategies. The AP funds' websites explicitly state these core values and how they have been achieved. The websites publish how the AP funds have voted in holdings, the investments' carbon footprint, and how they are contributing to the UN's global sustainable development goals. AP4's sustainability reporting follows this structure in jointly drafted guidelines. It describes the work on integrating sustainability into asset management while taking into account the Annual Accounts Act, GRI (Global Reporting Initiative) reporting standards, the United Nations Principles for Responsible Investments, carbon footprint reporting in accordance with the Task Force on Climate-related Financial Disclosures (TCFD), opportunities to contribute to the UN's Global Sustainable Development Goals, voting as a shareholder ,and the AP Funds' work in the Council of Ethics of the Swedish National Pension Funds (AP4, 2019).

It is argued by Sandberg et al. (2014) that the closed market environment of the AP reserve funds puts weaker force on the reserve funds to respond quickly to and think proactively about the government's ethics directive. Therefore, they might have less need to communicate complex investment choices to the public. Furthermore, in the absence of an active customer, Sandberg et al. (2014) argue that the beliefs and attitudes of financial analysts and investment managers have a big impact on the funds' decisions. Thus, the agents wield serious power over their principals. Hence, while the AP funds are officially obliged to show ethical and environmental concern in the management of their assets, it is neither specified in the law how they are to go about doing this, nor are the funds really evaluated against any such dimensions (Sandberg et al., 2014). It remains to be seen whether the new law will bring a change to this.

4. Conclusion

The path towards responsible investment has been different in Keva, the Finnish pension fund, versus the Swedish AP funds. The role of legislative drivers has been remarkable in the latter. The Swedish Parliament has actively reformed legislation on the investment policies of public pension funds. This has meant that the public pension reserve funds have had to consider more responsibility in their investments based on legislation. The creation of the Council of Ethics has further contributed to this by increasing transparency in investment decisions.

In Finland, the path has been different. There has not been much development in the legislation – or, more precisely, there has been none. Neither has been there much of a public debate. Yet, we can see that Keva has integrated responsible investments into their investment process in a holistic way. The investment policies are not as transparent as in Sweden, which might be because Finnish pension funds compete against each other and not all reporting related to investments is public. There is no formal cooperation in responsible investments in Finland. It seems that the increase in responsible investments has been an industry-driven process, where the gatekeepers within industry have been influential in promoting responsibility as part of the investment process. In other words, the process has been led by agents who are inspired by national and international developments. The general development of ESG and public commitments of pension funds have resulted in a situation in which all actors have developed their own guidelines and policies.

This is remarkable considering there are only two persons who directly work on responsible investment issues in Keva. The Finnish pension ecosystem fosters competition over customers, and the competition aspect has intensified in recent years. This has meant that previous cooperation, such as commonly agreed guidelines on responsible investments, has been abandoned. Keva's membership is based on legislation, hence it does not compete over customers in a similar way to the private funds; and yet, it is not as transparent in its investment activities as the Swedish AP funds.

In Sweden, the AP funds all receive a fixed share of contributions; therefore, they do not need to compete over customers and can freely engage in cooperation. The Ethics Council is a tool for cooperation: through its recommendations, it increases the transparency of responsible investments. Transparency is very important for public funds, as membership is compulsory. Transparency decreases the principal-agent asymmetry. It gives more information and helps principals in analysing the decisions taken by agents. The insured do not have any choice over investment policies; therefore, it is the industry insiders who influence the fund's responsibility approach. In Sweden, this approach is shaped by legislation, international processes, and the works of the Ethics Council. In Finland, the approach is shaped mainly by international processes and national adaptations of them.

The design of the pension benefit matters. In Sweden, the NDC (notional defined contribution) design and "brake" mechanism put all the risk related to pension financing on the pension benefit. The benefit can decrease if investment returns are low. This understandably increases public interest in investments, as it has a direct impact on the financial situation of retirees. This is not the case in Finland due to the DB (defined-benefit) design. Yet, if the level of the benefit is made more dependent on investment returns, the interest in investment policies could increase in Finland.

Europeanisation[14], understood as downloading EU directives, regulations, and institutional structures to the domestic level, has been weak in these two reserve funds. It could be argued that national reserve funds are one of the few financial institutions that remain largely outside the framework of EU legislation. Whether the EU's taxonomy will make a difference remains to be seen. It is probable that it will make reporting more uniform between different types of funds. Due to the strategic and economic importance of national reserve funds, it is to be expected, based on history, that they will follow their own pathways in investment policies.

This article has proven that it is very important to consider the whole ecosystem in which public reserve funds operate to understand the role that different drivers might play in advancing responsible investments. Further research would be needed on the more exact roles of the industry insiders who shape the responsible investment policies of public pension reserve funds, especially in the low-interest environment.

[14] For the definition, see Howell (2004).

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