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Introduction to the Special Issue on Sustainable Pensions: Do Sustainable Pensions Require Sustainable Investments?

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Abstract
This Special Issue addresses the concept of sustainability in pension systems from a wide range of perspectives. It examines the central questions raised about sustainable, socially responsible investments and other associated concepts by opening up a comprehensive discussion with an interdisciplinary approach. Normative trends and international cases are analysed in some detail concerning the situation of specific European Member States. Also, the concept of sustainability in European occupational pension schemes is questioned as an efficient vehicle able to assure adequate pension entitlements to all workers to avoid old-age poverty.

Keywords
Adequacy, environmental-social and governance investments, equality, European Law, fiduciary duties, occupational pension policies, pension funds, responsible investments, sustainable investments

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Over the years, policymakers have debated the adequacy of pensions entitlements and sustainability of pension systems at the national and international levels to envisage reform strategies in the face of new economic and demographic circumstances. Longevity growth, budget deficits, and low employment have made it harder for all pension systems to achieve financial stability and deliver on pension promises. In public pension systems, the sustainability and adequacy of social security entitlements depend on tax incomes as well as the level of contributions paid by employers and employees. Demographic challenges, together with labour market transformations, have stressed the importance of complementary retirement savings in securing the future adequacy of pensions (European Commission, 2012).

As a result, the notion of sustainability has started acquiring a twofold meaning. On the one hand, it has become a financial goal for pension systems to reach through structural reforms and the implementation of policies to support longer working lives. On the other hand, the concept of sustainability is becoming a vehicle to promote sustainable finance whilst maintaining the adequacy of pension benefits. However, this latter relationship has not been sufficiently explored so far. Therefore, this special issue would like to contribute to the scientific debate by answering the following question: to what extent (if any) is sustainability in investments required to ensure sustainability in pensions?

This introduction aims to discuss the dependency of pension sustainability on investment, taking account of broader definitions of sustainability. In order to do this, we will first present the definitional challenges that may arise in connection with sustainability in pensions and sustainability in investments. Secondly, we will set out to link the two discussions in order to understand the correlation between the concepts of investment and pensions and the current challenges this correlation implies. Finally, we will draw some preliminary conclusions on the topic.

Sustainability in pensions

The issue of sustainability in pension schemes has been a trending topic for several decades now. This has been triggered in particular by the well-known ageing transition and demographic change that most European countries are facing (Autenne, 2020). This question has been repeatedly raised in the European Policy agenda, where it is recognised that there are at least three main and concurrent goals or objectives of pension and retirement policies: (1) to provide adequate income in old age; (2) to ensure the financial sustainability of the system; and (3) to maximise employment (European Commission, 2010, 2012, 2015).

There are probably at least two definitions of sustainability in pension schemes, namely, a restrictive one and a broader one. The restrictive definition reduces the notion of sustainability to a mere question of the financial equilibrium of the pension system. A pension system is sustainable when its budget is balanced. Some authors argue that the restrictive view of sustainability might be prone to analytical errors, such as so-called 'tunnel vision', which consists in reducing one objective of a pension system to just one of its elements in isolation, without considering the potential effects it might have on other objectives (Barr, 2013: 9; Barr and Diamond, 2009: 13). Or, to put it another way, it means ignoring the fact that the objectives of a pension system are multiple and deeply interrelated (Barr, 2020).

Conversely, the broad definition not only includes a financial dimension, but also encompasses a discussion of the adequacy of pension schemes as a fundamental dimension of the concept of sustainability. The starting point for this special issue is a broader definition of sustainability. This is also the approach that some international organisations and policymakers outside the European sphere have taken towards the issue of sustainability (OECD, 2019, 2020).

Towards the end of the 20th century, the pension discussion was deeply marked by the World Bank's report, 'Averting the Old Age Crisis' (1994), which conceived of pension systems as having three separate yet complementary roles: (1) supporting individuals' saving to ensure income smoothing over each individual's lifetime; (2) redistribution, which involves shifting lifetime income from one person to another; and (3) insurance, which involves protection against financial and poverty risks (World Bank, 1994: 10). The report argued that a 'mono-pillar' or single-pillar public system, which most countries used to have, creates inefficiencies and distribution challenges that prevent the system from fulfilling all three main roles. Therefore, introducing various 'pillars' into the pension system – each with its own objective and methodology with which to achieve it – was seen as desirable because the efficiency of the system would improve. In fact, the report advocated a shift towards individual accounts, where contributions to the system would be invested in capital markets rather than public insurance (Wodsak and Koch, 2010).

Dividing the scheme into different pillars corresponding to each of the objectives would make it easier to comply with the objectives of the pension system. Moreover, a 'multi-pillar' system releases pressure from state pensions, which heavily rely on sufficient levels of employment and taxes. Other effects could be expected in consequence, such as investment growth, higher benefit levels, and stronger incentives for people to contribute to the system (World Bank, 1994: 15–16). The report served as a blueprint for policy discussions and policy reforms in Europe between the early-2000s and today (Barr and Diamond, 2009: 13). Furthermore, by adopting a similar approach and accepting some of the report's assumptions, other institutions have created variants of that multi-pillar system. One example is the International Labour Organisation (ILO) Multi-pillar Pension Model (International Labour Organisation, 2018: 2), in which sustainability refers specifically 'to the current and future capacity of the economy to bear the costs of social security'.

This model has not been exempted from criticism, the most notable of which comes from Barr and Diamond (2009). They argue that one of the problems with this model is its 'tunnel vision' with regard to the objective of sustainability in a pension reform, as well as its overconfidence in the potential benefits that this system might bring (Barr and Diamond, 2009). Nonetheless, in the last 20 years, most European countries have carried out pension reforms of different degrees of intensity on the basis of this model. These have involved such measures as changing eligibility criteria, changing pension indexation formulas, raising contribution rates, or a mixture of them all (Carone et al., 2016).

Even today, there is ongoing discussion of significant reforms to pension schemes. The two most recent cases were France and Belgium (Commission de réforme des pensions 2020–2040, 2014; Delevoye, 2019; OECD, 2019). In the aftermath of the COVID-19 pandemic, policymakers consider the main challenge faced by future reforms is providing short-term relief to workers, employers, retirees, and pension providers without creating potential negative long-term consequences for future retirement income adequacy. This being so, there is a special focus on ensuring that retirement saving arrangements and old-age pension systems remain sustainable and, at the same time, become more resilient (OECD, 2020:16). The starting point for recent reports is a broader definition of sustainability. However, it seems that problems with statutory pensions, or 'first-pillar' pensions, have received quite a lot of attention. The efforts have been focused on how to ensure an adequate pension whilst maintaining the system in financial balance. Indeed, the European Commission has stressed the importance of strengthening the second and third pillars in pension schemes of all

Member States as a way of alleviating some of the pressure on public pensions (European Commission, 2012, 2018).

Moreover, there have been voices appealing for a European-scale response to what seems to be a European challenge. This was the premise on which the EU High-Level Group on Sustainable Finance, Financing and Sustainable European Economy based its report (EU High-Level Expert Group, 2018). In the article by Hans van Meerten and Jorik van Zanden of the current Special Issue, the authors take a similar starting point. They argue that current and future issues surrounding the concept of sustainability in pensions require new thinking on how to shape retirement based not only on a broader conception of what sustainability entails, but also on a vision that goes beyond the limitations of national-level discussions. The authors present a set of trends in the context of the crisis in pension schemes that has been exacerbated by the current Covid-19 pandemic, such as the global shift from Defined Benefit (DB) towards Defined Contribution (DC) systems. In this context, the recently introduced Pan-European Pension Product (PEPP) might be a suitable European response to a European challenge. In essence, this product would not dispute the sovereignty of statutory public pension schemes or 'first-pillar' systems. In fact, consumer protection might be operational in setting a standard for pension providers and products in the 'second-pillar' occupational schemes, so as to correctly channel European Union citizens' savings towards long-term investments. At the same time, the PEPP guarantees two things: (1) encouraging and protecting the principle of freedom of movement within the territory of the Union, and (2) a standard low administration fee for any person who decides to acquire these products.

In a similar approach, Sarah Knoops's article raises the question of how, if at all, adequacy of occupational pensions (or second-pillar pensions) could serve as a proxy for understanding some of the sustainability challenges that pension systems might have. Beyond the discussions of first-pillar pensions, there are several challenges that need to be addressed but have been overlooked by pension scholars and policy makers. One example is the impact of the principle of non-discrimination on the adequacy of pension schemes based on a case study of the unified status of blue-collar and white-collar workers. In fact, part of the sustainability challenge of the pension systems also resides in the legitimacy of these systems vis-à-vis their participants. The distinction between the opportunities for different types of workers to access and profit from occupational pension advantages is not seen as justifiable under the principle of non-discrimination laid down in European regulations. Some courts have therefore requested a harmonisation of this regime within a 10-year period ending in 2025 (although recently postponed to 1 January 2030). The problem is that this decision might not guarantee an upward harmonisation for all workers in terms of benefits received. On the contrary, it could lead to a downward equalisation, and hence might harm the sustainability of the system in the sense of the legitimacy of the pillar system and its potential to provide adequate pensions.

Strengthening the adequacy of occupational pensions or purchasing a Pan-European Pension Product in the supplementary pension markets at a national or regional-level are certainly good steps towards overcoming the issue of the sustainability of European pension systems. However, this might not be sufficient. In fact, second-pillar schemes (occupational and supplementary plans) might actually entail an additional burden for individual savers due to the high complexity of such products. Providing insights from the Central and Eastern European countries, the article by Joanna Rutecka-Góra argues that the lack of clarity in pension plan products or financial knowledge among workers may result in inefficient and unsuitable products for savers themselves. The author also discusses the value of the right architecture in supplementary pension plans in terms of eliminating certain adverse phenomena, such as low coverage, mis-selling, and inadequate pension entitlements. Some Central and Eastern European countries have tried to encourage citizens to purchase one of these supplementary pension products. However, the high cost of these plans has undermined their complementary economic effect.

Sustainability in investments

Sustainability in investments has classically been approached from a purely managerial perspective. Pension policies are certainly social policies. But they also relate to financial aspects linked to interest rates, corporate finance, and the insurance market. The relationship between investments and pensions is highlighted, for instance, in the design of occupational pensions in the EU. They have increasingly gained relevance in recent years because of their purpose: providing retirement benefits in the context of an occupational activity.[1]

Occupational funds are institutions that operate on a funded basis. Funded schemes work under the premise that benefits depend on accumulated funds (Barr and Diamond, 2009: 8). These funds comprise assets, which are a mix of both contributions and the market returns from investing those contributions in financial markets. With that in mind, the issue of sustainability in investments has historically been restricted to analysing the ways in which the portfolio management of pension funds can ensure the highest possible returns for contributors, which determine the size of contributors' pension benefits. This is true of certain theories, such as the modern portfolio theory and temporal diversification theories. They limit themselves to looking at the best strategies for enhancing the performance of portfolio design and maximising long-term investment returns while minimising risk (Elton et al., 2013; Malkiel, 1996; Markowitz, 1952).

More recently, other aspects beyond maximising returns on investments have been included in the concept of sustainability in investments. Such approaches as sustainable socially responsible investing (SRI) and environmental, social, and governance investments (ESG) have appeared on the scene to shape the objectives of, and constraints on, investors. It seems, however, that the concepts of SRI and ESG are often confused. This is an example of what is called the 'definitional challenge' of sustainable finance: the need to clarify the scope and target of the concepts that have been included in the objectives and dimensions of sustainable investment (Autenne, 2020).

In their article, Lauren Daniels, David Pratt, and Yves Stevens introduce a further in-depth discussion of the conceptual relationship between SRI and ESG. On the basis of their findings, we can briefly define SRI as representing a condition attached to the decisions made by investors. Seen in terms of an ethical standard, investors must follow ethical codes in deciding on their investment strategies. Or, to put it another way, investors must seek other objectives beyond maximising profits or returns; that is to say, they must be mindful of social responsibility standards when they decide where and how to invest (Hellsten and Mallin, 2006). By way of example, an investor, such as a pension fund, that was pursuing an SRI policy would prefer to invest in businesses likely to have an aggregate positive long-term benefit, such as fair-trade agricultural enterprises, rather than in the tobacco or gambling industries. While investing in the latter industries might yield a higher return in the short term, it would produce a long-term negative social effect.

ESG is a *form* of SRI. It also requires investors to follow a moral standard when deciding where and how to invest. However, unlike SRI, ESG considers three factors when deciding on an investment: an environmental factor, a social factor, and a governance factor. Investors measure each one

1. Article 6, Directive 2003/41/EC, 3 June 2003.

of these factors as they see fit in order to decide whether or not an investment is desirable. However, the primary consideration of ESG remains a financial one. An investor must first and foremost consider the expected risk when deciding where to invest, not in terms of any socially negative effect, but whether the investment would be potentially more or less costly in terms of litigation costs or exposure risks. For instance, by guaranteeing higher returns, the coal and oil industries might be seen as a better investment than clean energy or forest preservation industries. However, coal and oil might in the long run be comparatively more susceptible to exposure or reputational risks for the investors and more prone to litigation costs. ESG criteria would hence point instead to investing in clean energy or forest preservation.

As a result of these trends, the notion of 'sustainable' finance has entered the discussion, as it is now an important driving force for investors, particularly pension funds. This is reflected in recent regulatory developments at the European and American levels, including the Directive (EU) 2016/2341 on the activities and supervision of institutions for occupational retirement provision (IORPs), the pan-European Personal Pension Product (PEPP) Regulation, the contributions of the European Insurance and Occupational Pensions Authority (EIOPA), and the European Commission legislative package on sustainable finance (European Commission, 2018). These regulations are concerned with improving transparency by disclosing the governance system for environmental, social, and governance-friendly policies within the governing bodies of pension systems themselves. Against this background, Daniels, Pratt, and Stevens also consider in their article how, if at all, regulations are shaped by an SRI or ESG approach and the consequences of any such decision.

When a regulation includes ESG considerations, investors must act in the beneficiary's *sole* interest. When SRI considerations are included – as in the discussions of the recent IORP II European regulation – the investor switches their behaviour by acting in the beneficiary's *best* interest. This distinction is best reflected in the way that pension fund managers' investment strategies are assessed by the contributors of private funds and the diametrically different investment outcomes in the two cases.

On a related point, in the article by Liudmilla Strakodonskaya, the author considers investors' ESG risks within the constraints of their fiduciary duty (FD). The author pinpoints two fundamental indicators for identifying this new ESG-FD concept. Firstly, an ESG risk must be seen as *material* or significantly relevant to the decision-making process. Secondly, this risk must be acknowledged by investors as part of their fiduciary duties when their hedging technique shows sufficient *effectiveness*. By comparing the European and American contexts, the author explores how recent regulations encourage or even impose the inclusion of ESG risks among the investor's fiduciary duties in reaching management decisions. Moreover, the author proposes a theoretical framework of how investors might incorporate ESG risks into their assessment and concludes that ESG risks can be equated with traditional financial risks.

It is apparent that the tension between the principle of maximising investments on the one hand, and ethical considerations on the other, is still the subject of intense debate, which is far from over. The issue that comes out of that debate is whether these legal regulations are sufficient to ensure that desirable investments are made by pension funds. At the end of the day, pension fund trustees are the ones who make the decisions. In his article, Ewan McGaughey claims that to ensure a broader notion of sustainability is included in pension fund investment, there is a need to shift towards more robust democratic governance of pension funds or, to put it another way, ensure that the wishes of the beneficiaries are included in the investment plans of occupational pension funds. A key point made by the author is that the notion of sustainability in pensions must rely not only on investment outcomes, but also on how democratically, loyally, and prudently these are governed. The article explores in-depth the growing movement to prohibit asset managers and banks from voting on other people's money without receiving express mandates. To this end, there is a proposal of Directive to establish 'the principle of democracy in capital, prudent investment, and sustainable pensions', inspired by the codetermination model in management, with strong representation of beneficiaries. This would be a way to take account of the interests of the beneficiaries when designing an investment plan and taking an investment decision. There might be positive externalities linked to adopting a governance scheme that elects some representatives who are also beneficiaries to management bodies, such as ensuring that ESG or SRI considerations are strictly adhered to. It is for this reason that this model could serve as a basis for a new EU directive on more democratic governance of pension funds and management.

Finally, the debate on sustainable investments has naturally focused on the behaviour of occupational fund managers given the significant unsolicited role they play as a consequence of the funds' investment weight. However, other types of pension fund have gone unnoticed, among which are 'buffer' funds and buffer fund managers. These are instruments that are incorporated into pension schemes with a view to alleviating short-term pressures, such as a solvency or liquidity deficit. In order to do so, the money allocated to these funds is also invested. It seems, however, that there are no clear governance rules to guide managers' decisions on investing the funds. In the article by Niko Väänänen, he presents the strategies, drivers, and rules of conduct for managers of these funds. He shows how they differ from, or relate to, the strategies, drivers, and rules of conduct adopted by standard occupational pension fund managers by focusing on a comparison of Swedish and Finnish buffer fund policies. The investment regulations applied to occupational pension funds are seemingly not applicable to buffer funds. Due to their key role, managers' investment decisions become crucial to the sustainability of these pension schemes. So, a bad investment decision could create a greater burden for the overall pension system's financial sustainability. That is why buffer fund management has developed a concept of 'public interest' to serve as a guiding principle for investment. It might be worthwhile exploring further how a similar approach could be incorporated into occupational pension investment decisions.

Conclusions

Sustainability of pensions requires sustainable investments. The classical restrictive definition of sustainability in pensions, understood as financial balance, correlates with the classical definition of sustainability in investment as maximising returns. However, in the modern world, these restrictive accounts of sustainability seem insufficient to explain the challenges faced by pension schemes and pension fund investments.

Sustainability of pension systems cannot ignore the importance of a financial dimension; but neither can it keep underestimating the adequacy dimension of pension benefits as if this was not crucial to the discussion on whether a pension system can be accepted as sustainable by its participants. The same goes for sustainability in investments. Even if the most important dimension of this concept is the importance of ensuring maximum long-term returns, other dimensions, such as socially responsible and environmentally sensitive investments, must increasingly be considered in decision-making on portfolio design and investment strategy.

A broader notion of sustainability in both pension schemes and investment strategies will complexify, but at the same time strengthen, the relationship between the two aspects. This Special Issue aims to shed light on some of the questions raised by that increasingly relevant relationship, while highlighting critical questions for further research on the topic.

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