ESG

Part of the problem, or part of the solution?

Laura Blows explores the complex debate around pension funds investing in the defence sector

Do pension funds want to be part of the problem, or part of the solution?

This is the question Netherlands Minister of Defence, Kajsa Ollongren, posed to Dutch pension funds in February this year, as she called on them to increase their investment in defence firms.

Whether to invest in defence is an important debate to have, Impact Europe head of policy and EU partnership, Jana Bour, states.

"How to ensure long-lasting peace? What is the role of institutional investors, such as pension funds in it? How to protect our communities from violent attacks? Is it ethical to help neighbours to defend themself? These are the questions we did not ask ourselves few years ago. The year 2022 *[the start of the Russia/ Ukraine conflict]* has changed that for Europe and this important debate now needs to take place," she says.

Two camps

This important debate centres around the thorny issue of ethics, with two opposing camps "both looking at UN Sustainable Development Goal 16 – to promote peace-ful and inclusive societies", Bour says.

The first camp believes that governments, investors, civil society and communities need to work together to find lasting solutions to conflict and insecurity and that strong defence systems, including within the cyber space, are a precondition for lasting peace, she explains.

The other camp believes "that there can be no peace and stability while financial institutions continue to fund the production of, and trade in, arms", Bour adds.

These opposing viewpoints can be tricky for pension funds as investors to navigate from an environmental, social and governance (ESG) perspective.

For Swedish pension fund, AP7, there has been a clear shift in the investment debate, "where the defence industry used to be a generally dubious investment, while at least some today think it's the other way around. Excluding the defence industry is the dubious approach", its spokesperson says.

However, the AeroSpace and Defence Industries Association of Europe (ASD) notes that, according to the experience of its member companies, "the biggest challenge for the European defence industry in terms of accessing private funding is currently that, due to ESG considerations, a significant portion of financial market actors in Europe is refusing to invest in companies involved in defence activities".

"These difficulties must be overcome as soon as possible to ensure Europe's ability to protect its citizens and territory. Financial market operators, such as pension funds, therefore have an important role to play with their investment decisions when it comes to ensuring the security, resilience and sovereignty of our societies and democracies," the ASD spokesperson adds.

The European Commission's (EC) new *European Defence Industrial Strategy*, published in March, states that the EU sustainable finance framework "does not impose any limitations on the financing of the defence sector".

It adds that "with the exception of weapons subject to prohibitions by international conventions signed by member states – which are therefore deemed by the EU to be incompatible with social sustainability – the defence industry enhances sustainability, given its contribution to resilience, security and peace".

Despite this, for some, investing in weapons is just too 'dubious' still.

The Global Alliance for Banking on Values (GABV) issued a Statement for Peace in February, calling on the financial industry to stop financing the production and trade of weapons and arms, stating that the "financing of weapons and arms does not qualify for, and is at odds with, any definition of sustainable finance".

PensionsEurope policy and communications officer, Gabrielle Kolm, also highlights the reputational risk of pension funds investing in defence. "There has been a big change before and after the *[Russia/Ukraine]* war, where we were in a demilitarisation era and now we are moving towards militarising." This needs to be communicated effectively to society, she explains, due to the reputational risk investing in defence may have for pension funds.

PensionsEurope CEO, Matti Leppälä, gives the 2007 example of some of the largest Dutch pension funds investing in clusterbombs and landmines, and the reputational uproar that generated.

It also should not be assumed that 'ethical funds' automatically exclude defence firms, as Morningstar Direct research from April 2022 found that, amongst sustainable funds globally, just 23 per cent have a stated policy of excluding military contractors, with 44 per cent of sustainable funds having some exposure to military contractors (compared to 60 per cent for other funds).

Defining which companies are actually involved in defence is more complex then may first appear. For instance, Leppälä highlights the firm Rolls Royce, which produces engines for planes. "What goes to the fighter planes? What goes to the commercial airlines?" he asks.

"The same defence material can be used for offence as well as defence, or in conflicts that the investor may deem to be unethical," he adds.

Many pension funds have navigated this complexity by investing in defence, but excluding those that manufacture controversial weapons banned under international law, such as anti-personnel landmines, and biological and chemical weapons.

For instance, AP7's spokesperson says there has been no recent change to its approach, and that it has no general restrictions against defence investment, "but we do blacklist companies involved in cluster munitions and nuclear weapons". AP7 invests in defence as part of the MSCI ACWI index, buying all its companies, bar those it blacklists.

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Increasing pressure

However, European pension funds may be taking a fresh look at their approach to defence, having received increased pressure to invest in recent months.

The EC's *Defence Industrial Strategy* stated that it would be reaching out to investors to "discuss their intensified participation, identify difficulties and find ways to stimulate private-sector engagement to support defence investments".

In November 2022, Dutch pension funds were called upon by the House of Representatives to invest more heavily in defence, with it claiming that investment in defence companies by the five largest pension funds in the Netherlands stood at just 0.1 per cent of total invested capital, while the government aims to increase the defence budget to 2 per cent of gross domestic product (GDP).

Meanwhile, in Denmark, its new defence financial framework largely points to public-private partnerships, "and this is strongly supported by the pension industry" the Danish trade association, Insurance and Pension Denmark, stated at the time.

"The broad agreement significantly expands conscription, which will of course also increase the need to build and upgrade barracks across the country. We are very positive about the fact that the agreement paves the way for public-private cooperation, where the pension industry's experience and expertise in construction can come into play, said its CEO, Kent Damsgaard.

"I have no doubt that we as an industry can play a large part in ensuring proper conditions for our conscripts and defence employees. At the same time, we must of course deliver a reasonable return to Danish pension savers," Damsgaard added.

Growing investment?

According to the GABV, the financial sector invested at least USD 1 trillion between 2020 and 2022 to support the arms industry.

Tikehau Capital head of private equity, Emmanuel Laillier, explains that the global supply chain for defence was weakened by the Covid-19 pandemic, resulting in major original equipment manufacturers considering recurring price increases to their supply chains.

"This unique landscape, characterised by strong market demand and the rebalancing of profit pools across the supply chain, presents an excellent entry point for financial investors to invest in the European aerospace supply chain," Laillier says.

So, are European pension funds being tempted to increase their investment in defence?

"I would say that in the Nordics, the pension funds are much more in favour of investing in defence. In the Netherlands, it is much more controversial, the debate is more heated, and in Germany I think the pension funds are not moving very much into this direction yet," Leppälä suggests.

In 2022, Finnish pension insurance company, Varma, adjusted its *Principles of Responsible Investment* and started to apply enhanced ESG monitoring to defence investments.

"Investing *[in defence]* is possible if activities relating to controversial weapons (for example the manufacture, export and storage of the components of controversial weapons) account for a minor proportion (less than 5 per cent) of the company's activities, and if the primary purpose of the weapons is to prevent conflicts and defend the sovereignty of countries that have signed international arms control treaties," it stated in its *Annual and Sustainability Report.*

Responding to the Dutch Defence Minister's renewed calls in February for greater pension fund investment in defence, ABP, the fund for Dutch state and educational workers, said that the amount it invests in arms companies has increased in recent years.

"We do not invest in weapons that are banned internationally and we look at the risk, return, costs and sustainability of an investment," it added.

ABP said that companies must issue shares or corporate bonds in order for pension funds to be able to invest – and only then "if the conditions are right".

ABP CEO, Harmen van Wijnen, said: "If governments need money to finance weapons, they can issue a government bond that pension funds and other large investors can invest in. We are always ready for a constructive discussion on this with the Ministry of Defence."

Commenting at the time, Dutch pension fund PME chairman, Eric Uijen, also highlighted how it invests in defence, with certain conditions, and so "I therefore do not understand the recent statements by politicians and generals that pension funds are part of the problem in European defence".

Speaking in March about the EC's new defence framework, Insurance and Pension Denmark deputy director, Tom Vile Jensen, said: "We have made it clear that pension companies are welcome to collaborate with both the Danish Armed Forces and invest in the defence industry, but that it is entirely up to each individual company to decide… If politicians want to succeed in raising much more capital from private investors, further targeted initiatives in the EU and Denmark may be needed to create greater acceptance and understanding of the investments."

According to Leppälä, pension funds are requesting sound, long-term policies that provide investment opportunities for them to invest in defence.

"Pension funds really want to be autonomous; they don't want to be pressured into investing in defence for political reasons, but instead approach it from the risk/reward point of view and also from the ESG criteria they have," he adds.

Despite the increasing focus and pressure, and complex nature of the ethical debate, it seems pension funds need the freedom to decide for themselves whether they feel investing in defence would be part of the problem or part of the solution.