Summary of the report

Background

The Swedish national pension system was reformed in the 1990s. The system that was created is still considered modern and innovative, even from an international perspective. The reform aimed at establishing a politically and financially stable system, by allowing a portion of the system to be fully funded, while another portion was formed as an autonomous and self-financing pay-as-you-go system. In connection with the pension reform, the regulation of the AP (National Pension) Funds, which manage the buffer capital of the pay-as-you-go system, was also reformed. The management goals of the buffer funds were slightly changed, and above all clarified, as a result of the pension reform. Furthermore, the organizational structure and the investment rules were considered outdated and inefficient. Following the reform of the AP Funds, the buffer capital– except for the part managed by the Sixth AP Fund – was apportioned equally among four new funds; the First, Second, Third and Fourth AP Funds. The investment rules for the new funds were identical and considerably more liberal than before the reform. For example, the opportunities to invest in equities and in foreign securities, as well as to take on currency risk, were significantly expanded. This new regulation was also considered modern and efficient compared to the regulations of many other pension funds at that time. The fact that capital was allocated to several funds was motivated in a number of ways, but it was noted that this solution implied that economies of scale were not fully utilized. The main arguments used were that the new funds should not be so large that they could disturb the functioning of the financial markets and that the creation of four funds would lead to a diversification of management risk. It was also argued that the creation of four funds would mean that an element of competition would be built into the system, leading to higher efficiency. It was finally argued that by creating several funds, the risk of political influence on governance of Swedish enterprises would be reduced.

Ten years have now passed since the reform of the AP Funds and there are reasons to review the structure and regulatory framework again, partly because the financial markets have developed, and partly because there are lessons to be learned from how the actual system has functioned. Moreover, it is always necessary to review existing regulations from time to time to ensure their efficiency and effectiveness. This is particularly important when regulation concerns the management of large buffer funds of a public pension system (at 30 June 2009 the buffer funds had, in total, net assets under management of SEK 745 billion (USD 110 billion)).

Also, in recent years criticism towards the current structure has grown. It has been argued that the total costs are unnecessarily high, and that by merging the funds, or by coordinating different functions, costs could be significantly lowered. The returns generated by the different AP Funds have also been criticized. Since the reform, the income index has increased by an average of 3.2 percent per annum, while the average return of the buffer funds has only reached 1.9 percent. This means that during this time, the AP Funds have not contributed to the financing of the pension system. Also, the 21.6 percent decline in 2008 was one of the reasons why the so-called balance ratio dropped below 1.00 by the end of 2008. As a consequence the automatic balance mechanism is activated. Furthermore, the results have been more or less the same in all four funds. It has been argued that the portfolio compositions of the funds have converged, so that the risk diversification that was expected hasn't been realized. Another criticism is that, not only have the absolute returns of the funds been low, but the active management itself has resulted in an accumulated total loss of 8.5 billion SEK (approximately 1.25 billion USD) before costs by the end of 2008.

To conclude, there are many reasons to examine if regulatory and structural changes may provide conditions for a more efficient management of the buffer capital.

Summary of the report 2009:4

The aim of this report

The aim of this report is to present a proposal for future regulation of the management of the buffer funds in the public pension system, which would provide more favorable conditions for cost-efficient management.

A more detailed explanation of the aim of the report follows:

- *Cost-efficient management* is leadership that fulfills as efficiently as possible the AP Funds' overall investment objectives as defined by the parliament, i.e. asset management should generate maximum returns to secure public pensions. This objective, which is described in the regulation, is thus taken as given. The report only analyses the pension system in isolation, i.e. no other socioeconomic consequences are considered. Cost-efficiency in the context of asset management means that the portfolio should be managed in such a way that the net return, i.e. return after all costs, is as high as possible, given the objective. Thus, the aim is not only to minimize costs. Furthermore, the special conditions of public pension funds, compared to most other institutional investors, i.e. the long investment horizon and the few flows to and from the fund, are taken into account in the report. The regulatory framework should be established in such manner that these unique conditions can be exploited in the most favorable way to maximize returns.
- The report deals with the *regulation* of the management of the buffer capital. In this respect, *regulation* does not only concern the actual rules of law, but also the organizational structure, for example the number of funds. The report also discusses certain governance issues, which are not treated explicitly in the regulation, but implied by it. It should be noted that the purpose of the report is not to evaluate the performance and the cost-efficiency of the existing funds. Such an evaluation is performed yearly by the government.
- The report focuses on how regulation, and governance, affects the *conditions* for a cost-efficient management. No matter how skillful a management organization is, it cannot be expected to perform better than what is preconditioned in the regulatory

framework. Consequently, it is important that legislators continuously evaluate if the regulation, and thus the conditions, can be improved.

- The report presents several *proposals* on how to improve the regulation. The intention has been to suggest the best ideas for the future irrespective of the current regulation and structure. Some proposals might thus be considered dramatic and drastic. However, it must be remembered that all proposals are just "proposals". In some cases, alternative proposals are presented. In many cases, further analysis is required to determine if a proposal is valid and how to design it in detail. While the report presents proposals for future regulation, it does not provide any concrete suggestions concerning the legal text. Neither does the report focus on the practical implementation of the suggested changes. The major aim of the report is to raise important issues for discussion and debate.

The content of the report

The report begins with a section that describes the public pension system and the role of the buffer capital. It is followed by a description of developments since the reform. Among other things, the report concludes that the income index performance and the low return from the buffer funds have brought pressure on the system. The report also includes a brief review of the results of the AP Funds. It shows, among other things, that all the buffer funds have underperformed considerably relative to their goals during the period 2001-2008. It also shows that the portfolio compositions of the funds do not differ much from each other, and that the total return from the buffer capital varies substantially between years. Finally, the report includes a short description of the negative results achieved by the active management and a description of the development of asset management costs. In 2007 and 2008, total costs (excluding transaction costs) amounted to roughly 20 basis points (hundredth of a percent).

Summary of the report 2009:4

Economies of scale

That economies of scale are present in the management of pension funds is natural. Fixed management costs are not affected by the size of the capital under management. A number of academic papers have shown a negative relationship between costs (as a percentage of the fund size) and the size of the fund. One study shows that if capital is increased by a factor of 10, the costs are reduced by 0.17 percentage points. It is clear that the cost reduction is smaller, the larger the fund. What is more surprising is that net return in relation to index appears to increase more than the costs are reduced, which is indicated in a number of studies. This might be due to the fact that it is easier for a large fund to attract and build competence and good governance, and also to gain access to more favorable investment opportunities. In the Netherlands and Canada, the supervisory authorities have adopted this strategy and now permit large pension funds to compete for external assignments in order to take advantage of the economies of scale, to the benefit of all the insured.

If the capital of the Swedish buffer funds were pooled into one fund, it would not even be among the twenty largest global global pension funds. Thus, the new fund would be large, but not exceptionally large. Funds like the Norwegian Statens Pensjonsfond Utland, the Dutch ABP, and the American Calpers would all be two or three times larger.

So, why did legislators decide not to fully exploit the economies of scale in the AP Fund reform in 2000? In the preparatory work of the AP Fund Act, four main arguments are used to justify the creation of four identical funds. This report analyses whether these arguments are still valid and the conclusions are presented below. Note that the first two arguments were stated explicitly in the preparatory work, while the other two, although mentioned, probably were perceived as less important.

- *To reduce such market impact that could impede efficient fund management and disturb the market.*
  This argument is no longer valid. The financial markets have developed during the last 10 years; new instruments are now available; and investment strategies have changed. There's only minimal risk that a merger of the funds would result in a buffer fund that would be restricted by its size.

- *To diversify management risks.*
  This argument is no longer valid. Only minor effects from diversification have been observed. On the contrary, competition appears to have resulted in very similar portfolios and herd mentality which have in turn increased the total risk in the system.

- *To enable competition in order to achieve a downward pressure on costs and to improve results.*
  This argument is no longer valid. Management performance doesn't appear to have improved as a result of competition. There may have been some pressure on the costs in the system, but net results from active management have been poor in all funds.

- *To reduce the risk of possible political influence on the governance of Swedish enterprises.*
  This argument can still be valid. A management structure with four separate and independent funds is likely to somewhat reduce the possibility of political influence on governance.

The only argument which still can have some validity is thus the argument that the existence of several funds might reduce the risk of harmful political influence. However, the structure of four funds does not solve the problem completely, and the total cost for this solution is high. There is, though, a simple solution which makes a merger of the four funds possible, without either putting restrictions on the buffer fund's exposure toward the Swedish equity market, or affecting the availability of institutional risk capital to Swedish enterprises. The solution is to only allow indirect holdings of Swedish equity, either through investment funds or derivatives. This way, the fund can profit from the return of the equity market without exercising the voting rights. The voting rights will instead be held by fund management companies which are selected to manage the Swedish equities of the buffer fund. The buffer fund can obviously require that corporate governance of the management companies is held to high standards, and it can also choose to invest in funds with long investment horizons.

In this regard, how large would potential gains be if advantage was taken of economies of scale? During the project, CEM Benchmarking was hired to make a rough estimation of the possible effects on costs by merging the First-Forth AP-funds into one fund. By using a database of detailed actual costs from a large number of international pension funds, the expected cost reduction was estimated to be 4.7 basis points. This figure would correspond to an estimated cost reduction of more than 300 million SEK a year. Also, there are other studies showing that net returns tend to be substantially higher in larger funds. Based on such results it is estimated, but of course very roughly, that results could potentially increase by about 700 million SEK a year, if all the capital was managed in one fund. Although it is not possible to make an exact calculation of the potential gains, it is obvious that a merger can have several significant positive effects on the buffer fund performance. Given these circumstances, and counting on the fact that any possible negative consequences of a merger can be dealt with, there is no reason to choose a solution with two or three funds or to only increase cooperation between funds, at least not from the point of view of the pension system. These kinds of solutions would not fully profit from the possible advantages of economies of scale, but instead impose an unnecessary cost on the pension system. It is proposed in the report that the buffer assets now managed by the First, Second, Third and Fourth AP Funds in the future should be managed by one single fund.

Governance structure

To ensure efficient portfolio management, governance must be designed so that the best result can be achieved while still pursuing the goals of the principals, i.e. current and future pensioners. This is possibly even more important than taking advantage of economies of scale. The report describes, based on agency theory, various difficulties regarding governance of public pension funds. It states that the challenge is to make all concerned parties, so-called agents, in the pension system, e.g. the parliament, the government, the board members and the employees of the AP Funds, act in a way that best serves the ultimate principals. Governance problems concerning public pension funds are obviously not unique to Sweden and many of the discussions and

Summary of the report 2009:4

proposals concerning governance are based on a study (Yermo, 2008) of the best practices within the OECD countries.

This part of the report begins with a chapter on governance that raises the idea that the buffer fund should be managed by an authority under the parliament instead of under the government. It discusses the establishment of a council, similar to the General Council of the Central Bank. One of the main tasks of such a council would be to elect the board of the buffer fund. The fundamental idea is that governance would improve if it were exercised closer to the principals. The council would only have one specified duty, while the government have plentiful. In the discussed proposal the governance could also be better structured and more transparent, and it would be easier to have a long-term focus. This would contribute to improved credibility concerning the governance and the management of the buffer fund. All together, this could result in more efficient governance and improved conditions for portfolio management, which is likely to result in a better performance of the fund.

Subsequently, the report reviews a number of concrete governance issues that influence efficient management. These issues are relevant irrespective of whether the buffer fund is managed by an authority under the parliament or under the government. The report finds that the current objectives are vague and are difficult to interpret. The law delegates to the boards to define their own objectives. As a result the objectives vary to some extent from fund to fund. Also, this makes it difficult to evaluate the performance of the funds, which may lead to reduced efficiency.

Furthermore, based on best practice, the report concludes that the current boards are too large, and it suggests that the size is reduced to seven board members in order to enhance efficiency. The report also points out that more relevant skills and experiences are needed on the board of a buffer fund. Currently, there is a shortage of competence within asset management, that is crucial to making decisions on strategic issues about allocation and investment models. Therefore, the report suggests that a nomination committee, which in turn also should possess relevant competence, should nominate candidates, adhering to a professional, structured and transparent recruitment process. In the current system, four board members are elected following proposals from organizations representing employers and employees. This system is suggested to cease. The nomination committee should be responsible for electing a board that is well constituted and holds the relevant skills and experiences. To be able to benefit from the advantages of a long-term investment perspective, the board must have relevant skills and a high level of integrity. It is also important that the board takes responsibility for building trust in the pensions system and buffer fund management within the public sphere, which means that outreach and communication skills are also important qualifications. The necessary qualifications expected in board members should be clearly stated. A review of current board remunerations is necessary. The remunerations should be sufficient size to attract persons with the most relevant background and to stress the importance of the assignment. The report discusses the possibility of changing regulations that currently bar foreign citizens who may otherwise be qualified candidates, from serving on the boards. According to current laws, it would be a violation of the constitution to recruit a foreign citizen. Finally, the report states that evaluations of the board's performance are essential to guarantee efficient governance. The evaluation of the fund's results in relation to its objectives must be performed over a longer period, given the long investment horizon of the pension fund. However, the contributions of each board member should be continuously evaluated. The report proposes that board members serve one year terms if the buffer fund is an authority under the parliament, and otherwise for three years.

The report pays special attention to the creation of protection against harmful political control, i.e. attempts to use the buffer funds for purposes that do not benefit those insured in the system. The management of the buffer fund should have a long-term horizon. The buffer fund is a part of a pension system which was established with the intention that it should be politically and financially independent, and to have an indefinite life span. A government has many duties apart from managing the pension system, and probably a shorter horizon. To make the buffer fund an authority under the parliament, governed by a council, could be a solution. The report discusses, mainly in light of Yermo's description of best practice, a number of ways to protect the pension system from political decisions that wouldn't benefit it. A transparent and structured recruitment process, run by a nomination committee, could strengthen the protection, and so

could a stronger board with the right level of competence and high degree of integrity. Requiring board members to report any possible attempts at influence that contradict the law and preparatory legal framework could also increase protection.
It is highly important that the board can create confidence and trust in the pension system, and especially in the management of the buffer capital. Trust is a prerequisite for the board and the management to be able to benefit from the long horizon. Canada mandates that the chairman of the board of the public pension fund, and its CEO, must present the fund's strategy and results at public meetings every two years. A similar system in Sweden would be valuable.

To conclude, the report presents several suggestions to improve the governance structure. It is likely that proposals and ideas related to the governance would have a great impact on the efficiency of the management. The size of the efficiency gain is, however, hard to estimate.

Investment rules

The report also discusses how quantitative investment restrictions can prevent a cost-efficient management of the buffer fund. For example, such restrictions might cause a biased view of risks and that could be excessively limiting, to the point that an appropriate portfolio allocation cannot be reached. This might be a consequence of the development on the financial markets, and creation of new instruments, which might render the regulation outdated. If the fund's possibility to take risk changes over time, the quantitative rules might prevent the fund from investing in the most appropriate portfolio for the pensions system. Another problem is that if the prices of one asset class change, all portfolio weights will change, causing a risk for violation of limits and forced realizations of assets.

The current regulation of the investments of the First through Fourth AP Funds was considered modern at the time of the reform. It allows much more flexibility than the earlier rules. Today, it is clear that the investment rules are unnecessarily restrictive in some areas, given the purpose of the buffer funds. Unlisted assets must not exceed 5 percent of the total assets. This hampers the funds from benefitting from their long-term investment perspectives and it might cause unintended breach of rules when the value of quoted assets in the portfolio drops. Today the fund is not allowed to invest in commodities, although commodities might contribute to diversification and inflation protection. The fact that the value of fixed income assets must amount to 30 percent of the portfolio can also be an inefficient restriction.

The purpose of investment rules is to limit risk, and to ensure there is enough liquidity when needed. In combination with the improvement of the governance structure as suggested above, especially concerning the composition of the board, a qualitatively oriented regulation would create better conditions for an efficient fund management than existing rules. According to Yermo, qualitative rules correspond to best practice for public pension funds. Qualitative regulation would also be in line with the prudent person principle, which, for example, applies for occupational pension funds within the European Union. Qualitative rules would clarify that it is the board's full responsibility to make decisions on risk level and portfolio allocation. Qualitative rules are normally combined with a requirement for adequate internal processes for management of investments and risks. Such processes are most likely already implemented in the AP Funds. However, supervision by an external authority should be considered.

Even after a change to a qualitative regulation, some quantitative rules can be applied. The following rules are suggested:

No more than 10 percent of the fund's assets may be exposed to a single issuer.

The fund must not own equity, listed or unlisted, in Swedish companies, if voting rights are associated with the ownership (with some exceptions, e.g. equities in own real estate companies, shares/equities in unlisted private equity companies).

The voting rights associated with the ownership of shares/equities in unlisted Swedish private equity companies must not exceed 30 percent of the total voting rights in the company.

The chapter on investment regulation discusses the difficulties of successful active management, especially for public pension funds. It concludes that it is particularly difficult to outperform indices in many markets, and that it can be even more difficult for public pension funds than for other investors. Yet, it does not suggest the prohibition of active management. The opportunities to create active returns vary over time and among markets and investment styles. Prohibiting active management could impede efficient fund management. The report's suggested changes to the government structure should result in a board that has both the ability to judge, over time, whether active management can result in a higher net return in different investment areas, and the strength to choose passive management if merited.

The Sixth AP Fund

The Sixth AP Fund also manages buffer funds in the public pension system. However, the sixth fund holds a different position than the others in many respects. It has the same goal as the other buffer funds (i.e. it should manage the capital to the benefit of the pension system, with a requirement for high long-term return and diversification), but it is restricted to investing mainly in small and middle-sized unlisted Swedish companies. The fund was established in order to supply risk capital to small enterprises and to support growth in Sweden.

The report suggests that the Sixth AP Fund is closed down, and that its assets are pooled with the other buffer funds. There are several reasons for this. Investments in unlisted assets are important in a pension fund's investment strategy, and it is both natural and efficient to gather management skills in one place and to benefit from economies of scale. This change would also facilitate the allocation decisions regarding the total assets in the buffer fund. The current structure is somewhat odd, with a capital amounting to 16 billion SEK being managed in a fund separate from the others. This makes governance difficult, which might be one reason for the poor results of the fund. The fund is also managed separately from the pension system as a whole, since there are no flows between the system and the Sixth AP Fund. Moreover, the current structure actually encompasses a quantitative investment restriction since the Sixth AP Fund mainly only can invest in Swedish unlisted companies. If there is a shortage of risk capital to Swedish enterprises, this must be dealt with in another way.

Summary of the report 2009:4

Recommendations

The report presents a number of possibilities to improve the management of the buffer funds. Taking advantage of all opportunities requires extensive changes of legal framework as well as organizational structure. It is likely that prioritizations will have to be considered. The report gives the following recommendations:

- *Economies of scale*:
  Immediately initiate preparations to merge all buffer funds into one fund.
- *Governance structure*:
  As soon as possible change the governance structure in order to strengthen the board:

  - The board should be reduced (seven board members is suggested).
  - Employer and employee organizations should not nominate candidates.
  - A nomination committee should be responsible for selecting the candidates.
  - The recruitment process must be transparent, structured and well-founded.
  - Board remuneration should be increased.

- *Investment rules*:
  It is imperative that investments in unlisted assets be allowed, as well as investments in commodities.

Because of the size of alternative costs, it is recommended that a committee is appointed as soon as possible to analyze the issues further and to present a detailed proposal for changes in the regulations. It is important to bear in mind that the uncertainty concerning the future of the current AP Funds can in itself cause costs.

Forming a new authority under the parliament requires an extensive investigation of constitutional and other legal issues. Furthermore, it implies constitutional changes, which means it's uncertain when such an authority could be established. However, the pension system's timeline is very long.