

OECD Working Papers on Finance, Insurance and Private Pensions No. 17

Review of the Swedish National Pension Funds

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https://dx.doi.org/10.1787/5k990qtkk6f8-en

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Abstract

REVIEW OF THE SWEDISH NATIONAL PENSION FUNDS

Abstract: This paper provides a review of the Swedish National Pension Funds based on international good practice and OECD guidelines. The paper focuses mainly on the general size and structure of the funds, the investment framework and the governance of the funds. The internal management of the funds appears to be strong, with governance and risk management structures in place that appear to broadly follow OECD guidelines.

The report concludes that the AP funds could benefit from having one clear and specific long-term investment objective, set by an independent committee answerable to Parliament, for all the AP funds against which their long-term performance can objectively be measured. The mandate and role of the AP6 fund could also be clarified.

The report recommends the implementation of the prudent person rule as restrictive investment regulations are leaving the AP funds with less room to adopt varying investment strategies, and thus takes away some of the potential benefits of competition and diversification from having four different funds. Finally the selection process for the Governing Boards of the funds could be made more transparent and rigorous.

JEL codes: G18, G23, G28

Key words: pension funds, public pensions, reserve funds, governance, Swedish National Pension Funds, AP Funds, investment framework

Résumé

EXAMEN DES FONDS NATIONAUX DE PENSION EN SUEDE

Résumé : On trouvera dans cette note un examen des fonds nationaux de pension en Suède fondé sur les bonnes pratiques menées dans les différents pays et les Lignes directrices de l'OCDE. La note met principalement l'accent sur le montant observé en général et sur la structure des fonds, le cadre des investissements et la gouvernance des fonds. La gestion interne des fonds apparaît saine, et il semble que les structures de gouvernance et de gestion du risque qui sont applicables soient conformes dans l'ensemble aux Lignes directrices de l'OCDE.

L'étude conclut que les fonds AP gagneraient à se fixer un objectif à long terme d'investissement clair et spécifique, déterminé par une commission indépendante responsable devant le Parlement, pour tous les fonds AP par rapport auxquels leurs performances à long terme peut être objectivement mesurées. Le mandat et le rôle du fonds AP6 pourraient également être clarifiés.

Cette étude recommande l'application de la règle de prudence, dans la mesure où des réglementations restrictives en matière d'investissement laissent peu de marge de manœuvre aux fonds AP pour faire varier leurs stratégies d'investissement et les privent donc des avantages potentiels de la concurrence et de la diversification qui résultent de l'existence de quatre fonds différents. Enfin, le processus de sélection des membres des comités directeurs des fonds pourrait être rendu plus transparent et plus rigoureux.

Codes JEL : G18, G23, G28

Mots clés : fonds de pension, pensions publiques, fonds de réserve, gouvernance, fonds nationaux de pension suédois, fonds AP, cadre d'investissement

Sammanfattning

ÖVERSYN AV DE SVENSKA AP-FONDERNA

Sammanfattning: Denna studie ger en översikt av de svenska AP-fonderna baserat på internationell praxis och OECD: s riktlinjer. Studiens fokus ligger på ett övergripande plan och behandlar nuvarande storlek och struktur av AP-fonderna, ramarna för kapitalförvaltningen och fondernas styrning. Fondernas interna förvaltningsorganisation verkar vara starka med en effektiv styrning av och god riskhantering i linje med OECD's riktlinjer.

Rapporten konstaterar att AP-fonderna skulle dra nytta av att ha ett tydligt gemensamt mål för alla AP-fonderna mot vilka de långsiktiga resultaten kan mätas på ett objektivt sätt. Målet bör fastställas av en oberoende kommitté ansvarig inför parlamentet, Sjätte AP-fondens roll i pensionssystemet och dess förvaltningsuppdrag bör också förtydligas.

Rapporten rekommenderar att ersätta placeringsrestriktionerna i lagen med en aktsamhetsprincip då nuvarande regler minskar AP-fondernas utrymme till flexibilitet att vidta olika investeringsstrategier. Därmed går en del av de potentiella fördelarna med konkurrens och diversifiering från att ha fyra olika fonder förlorad. Slutligen kan urvalsprocessen för fondernas styrelser tydliggöras och bli mer strikt.

JEL-koder: G18, G23, G28

Nyckelord: pensionsfonder, offentliga pensioner, reservfonder, styrning, Sveriges pensionsfonder, AP-fonder, investeringsram

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EXECUTIVE SUMMARY

The OECD has been requested by Sweden's National Pension Fund Inquiry to provide high-level guidance as to international experiences and good practices in relation to the Inquiry's review of the First through Fourth National Pension Funds (AP1 through AP4) and the Sixth National Pension Fund (AP6).

The Inquiry has been tasked by the Swedish government to look at a number of both broader and specific issues such as the overall strategic investment objectives of the funds, whether the existing investment restrictions on the funds are appropriate, the level of efficiency of the current fund structure, board member requirements, accounting and auditing of the funds and scope and timing of government evaluations.

This paper summarizes the OECD's proposals for the Inquiry's consideration. The paper does not attempt to answer all of the questions posed by the Swedish government to the Inquiry, but rather presents an international perspective on some of the broader, key issues based on OECD Member Country experiences and OECD good practices. The comments made in this paper focus mainly on the general size and structure of the funds, the investment framework and the governance of the funds.

On a combined basis, the Swedish AP Funds are large compared to public pension reserve funds in most other countries, although significantly larger funds exist in the United States, Japan Norway, Saudi Arabia and Korea. The internal management of the AP funds appears to be strong with governance and risk management structures in place (including experienced leadership and engaged board members) that appear to broadly follow OECD guidelines.

Sweden's four-fund structure is unique among global pension reserve funds. One of the most contentious issues to be examined by the Inquiry is whether the four-fund structure has been effective. The original idea behind the design of the AP funds as four distinct and independently operated entities was to reduce the impact of the funds on the domestic market, diversify management risk, enhance performance through competition and to mitigate the risk of political interference (Björkmo and Lundbergh, 2010), as well as to diversify strategic risks. Arguments against a multi-fund structure have tended to focus on the level of costs, potential for economies of scale from having a smaller number funds, consolidating expertise and the number of board members, as well as potentially stronger governance and greater resilience from outside influence from having one large fund rather than several smaller funds.

The OECD has no strong view as to whether the current number of funds or fewer funds is optimal and leaves this to the Inquiry and the Swedish government to establish. However, it should be noted that the other reserve funds around the world do not seem to encounter major difficulties operating on a centralized basis. In terms of operating costs, the AP funds 1 to 4 do appear to be in line with their international peers, even on a disaggregated basis, and low compared to the aggregated operating costs of traditional pension funds in OECD countries. It is important to note that the risk of political interference of reserve funds is pervasive especially in times of economic distress. Having a multi-fund structure may work to increase the independence of the funds' operations, yet on the other hand, the visibility of one large fund as opposed to several small funds may also serve to protect it from outside influence. The risk of political interference is, however, not necessarily tied to the number of funds. Finally, it is important to note that strong governance and oversight structures are powerful measures in mitigating political risk, but cannot altogether eliminate it.

The over-arching investment mandate of the AP Funds 1 to 4 encoded in Swedish law is to provide as high investment return as possible, while not taking undue risk. The funds must also be in a position to pay out benefits if requested by the Swedish Pensions Agency. The actual interpretation of this mandate is left

to each of the funds, and the resulting investment objectives are disparate and inconsistent. The lack of a distinct, specific and long-term investment objective that is consistent across the funds has meant that the funds' performance has had no clear and objective target against which their performance could be measured.

A more powerful, consistent and specific investment mandate across the AP funds that is approved by Parliament would help make the evaluation of their performance more transparent and easier to establish. This investment objective could be expressed in terms of a targeted funding ratio, cash outflow schedule and a long-term real rate of return target and would serve to keep the funds answerable to the electorate on a more objective basis. Furthermore, changes to the funds' structure based on future reviews may be more readily motivated based on such an objective measurement, as could it help to protect the funds against undue political pressure.

Our main suggestions for consideration by the Inquiry Board are summarised as follows:

- **Establish an independent committee that is responsible for issues related to the AP funds:** This independent committee should be answerable to Parliament (and could, for instance, potentially be a part of or an extension of the current parliamentary Pensions Group). Its role would be to "own" issues related to the AP funds, such as establishing the over-arching investment objective, establishing performance measurement criteria, nominating board members. The committee could also serve to promote public awareness of the role of the AP funds within the Swedish pension system.

- **Establish one targeted and measurable long-term investment objective for all the AP funds:** One clear and specific long-term investment objective should be set for all the AP funds against which their long-term performance can objectively be measured. This over-arching and long-term investment objective should have Parliamentary approval. It should be clearly expressed and could directly take into account the expected timing and amounts of the cash in- and out-flows of the AP funds, the expected financial impact of demographic changes, the long-term funding target of the funds in relation to the pension system's liabilities and the level of expected investment return versus the acceptable level of risk that the balancing mechanism would be triggered and pensioner benefits cut.

- **Measure performance against this long-term investment objective:** Currently, the performance of the funds seem to be mainly measured in relation to each other and based on the level of their annual operating costs (which appear to be low if compared internationally). This appears largely to be due to the lack of a clear and specific investment objective that would apply consistently to all the AP funds. Performance should primarily be measured directly against an over-arching and long-term investment objective, as described in the bullet point above.

- **Implement the Prudent Person Rule:** As a general principle, the OECD supports the implementation of the prudent person rule. If the goal is to reduce risk, then this can be done specifically in the over-arching investment objective described above and in the strict governance and oversight of the funds rather than via specific investment restrictions. Such restrictions could in fact lead to suboptimal portfolios and over-exposure to certain types of assets. Furthermore, restrictive investment regulations leaves the AP funds with less room to adopt varying investment strategies, and thus takes away some of the potential benefits of competition and diversification from having four different funds. The implementation of a less restrictive investment framework should furthermore be supported in each fund by a written investment policy describing primarily how each fund would intend to meet the over-arching investment objective and their strategic asset allocation policies.

- **Clarify the mandate of the AP6 Fund and align the governance and operation of the fund with that mandate:** The mandate of the AP6 fund is to invest its assets in the Swedish private equity market, within the framework for what is in the best interest of the pension system. Unlisted assets and other alternative investments can be an important investment class for pension funds. However, it is unclear to what extent such investments in and of themselves are in the best interest of the pension system. If AP6 is to be maintained, then its role and importance within the pension system should be clarified. As investment in unlisted assets takes expertise and specialisation, one potential option could be to embed the AP6 fund and its exposure to unlisted assets within the other AP funds. Any investments made by AP6 would then need to be motivated within the overall framework of the Prudent Person Rule.

- **Strengthen the selection process for the Governing Boards:** The selection process of the governing boards of the AP funds currently appears to be ad hoc and not transparent. The OECD supports implementing fit and proper criteria for board members, a balance of skills between members and a transparent and rigorous selection process. Furthermore, there appears to be no particularly compelling reason to limit Governing Board members to Swedish citizens. Board Member candidates would need to follow a transparent nomination process, and meet pre-defined fit and proper criteria for the Board in aggregate.

The guidance and proposals made in this paper draw on previous work done by the OECD and are based on international good practices identified in this previous work. In recent years, the OECD has analysed the governance and investment arrangements of public pension reserve funds around the world and monitored their investment performance in the OECD's annual Pension Markets in Focus newsletter.

The basis for the proposals made in this paper is the OECD's Core Principles of Occupational Pension Regulation and the associated guidelines on "Pension Fund Asset Management" and "Pension Fund Governance". Particularly relevant to this review is the OECD's 2008 report Governance and Investment of Public Pension Reserve Funds in Selected OECD Countries. Furthermore, the OECD has done similar reviews for the pension reserve funds in Japan and Korea.

INTRODUCTION

The OECD supports the establishment of reserves to prefund social security benefits as these funds allow governments to respond to the fiscal pressures from ageing populations (tax smoothing /improving debt position of the government) and international diversification can provide (long-term) exposure to other countries experiencing less of a demographic decline. However, the OECD also recognizes that such funds face some unique challenges as compared to traditional pension funds due to their size, their broader mandate and the sometimes difficult balance between political and economic considerations.

The pension reserve system in Sweden has a unique structure in that it is divided into four separate funds, known as AP1 through AP4. One quarter of the social security contributions made towards the state pension system are directed into each of these four funds. In turn, each of the four funds pays out one quarter of benefits due from the state pension system. In addition there is a separate AP6 fund which invests exclusively in private equity. The AP6 fund receives no contributions and pays no benefits.

The AP7 fund relates to the mandatory individual pension savings accounts and is not subject to the current Inquiry. No further mention of AP7 will be made in this paper.

Based on our interviews, it is our understanding that the AP Funds 1 through 4 have no formal obligations with respect to future pension payments, but can be called on by the Pensions Authority to make payments due. In effect, the funds act to an extent as a "clearinghouse" for cash flows in the state pension system, where on a monthly basis, one quarter of contributions into the state pension system are deposited into each of the funds and one quarter of payments due are paid out of each fund. Any excess of contributions in over payments out would remain in the funds and any shortfall would be a loss to the funds.

As of year-end 2011, the total assets in the AP Funds 1 through 4 plus AP Fund 6 was SEK 873 billion which is equal to 12% of the total liabilities of the state pension system (Pensionsmyndigheten, 2010). Over the coming thirty years due to mainly demographic changes, the payments to be made from the pension system are expected to significantly outsize the payments to be made into the system and by 2040, the size of the buffer funds AP1 to 4 and 6 is expected to have decreased to SEK 400 billion (Ministry of Finance, 2011).

STRUCTURE, SIZE AND OPERATING COSTS OF THE FUNDS

Multi-Fund Structure of the AP Funds

Sweden is unique in that it is the only country which utilizes a structure of multiple pension reserve funds. The multiple fund structure was originally set up for the following reasons (Björkmo and Lundbergh, 2010):

- To reduce market impact;
- To diversify management risks;
- To allow competition to reduce costs and improve performance; and,
- To reduce political interference.

Four identical funds were also established to diversify strategic risks (hence the intension that the Boards should independently set the goal and decide on asset allocation) – as described in the AP-fund legislation.[1]

Historical factors appear to have played a part in the creation of the multi-fund structure, as well. The single pension reserve fund that was the predecessor to the AP funds had several boards that were transformed into the boards of the AP funds 1 to 4 at their creation. Furthermore, the AP6 fund received its assets from a portion of the disbanded wage-earners funds ("löntagarfonder") that existed in the 1980's and consisted mainly of pooled profits from Swedish corporations (Whyman, 2004 and Björkmo, 2009).

The question has been raised by the Inquiry as to whether the current structure of four AP funds plus the AP6 fund should be maintained? Obtaining economies of scale could argue for a smaller number of funds, whereas the risk of concentration of power and market impact could argue for several smaller and independently operated funds. Whether the multi-fund structure has achieved the four goals as listed above, and the relative importance of these four goals, will be left to the Inquiry Board and the Swedish Parliament to establish.

From an international perspective, other reserve funds around the world have either not specifically identified the four goals listed above in relation to having a single fund versus several funds, or they have approached these challenges in different ways.

Size of Funds

The size of the National Pension Funds in Sweden is large in absolute terms and as a percentage of GDP - with only the Saudi Arabian and Norwegian funds representing significantly higher percentages of GDP, with the Japanese and Korean funds being on a par.

[1] Prop.1999/2000:46 p.116-121

Table 1. Size of public pension reserve fund markets in selected OECD countries and other major economies, 2010

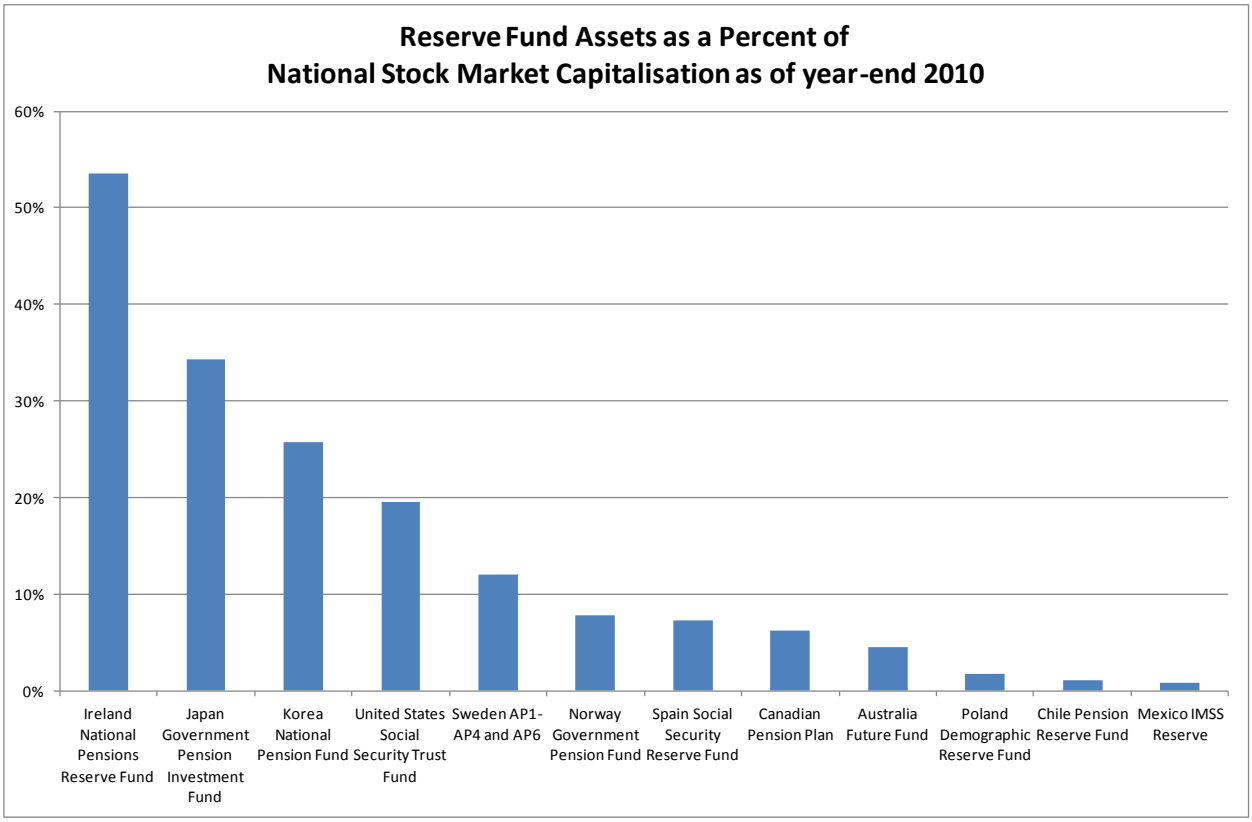
Country	Name of the fund or institution	Established in	Assets		
			USD billions	% of GDP	% increase
Selected OECD countries					
United States	Social Security Trust Fund	1940	2,609.0	17.9	2.7
Japan (1)	Government Pension Investment Fund	2006	1,312.8	25.9	n.d.
Korea	National Pension Fund	1988	280.4	27.6	16.7
Canada	Canadian Pension Plan	1997 (CPPIB) / 1965 (CPP)	136.0	8.6	13.0
Sweden	National Pension Funds (AP1-AP4 and AP6)	2000	124.7	27.2	8.1
Spain	Social Security Reserve Fund	1997	85.3	6.1	7.3
Australia	Future Fund	2006	65.8	5.5	8.4
France	Pension Reserve Fund	1999	49.0	1.9	11.1
Ireland	National Pensions Reserve Fund	2000	32.3	15.9	9.3
Belgium	Zilverfonds	2001	23.3	5.0	4.3
Norway	Government Pension Fund - Norway	2006	23.1	5.6	16.9
Portugal	Social Security Financial Stabilisation Fund	1989	12.8	5.6	2.5
New Zealand (2)	New Zealand Superannuation Fund	2001	11.2	7.9	17.1
Chile	Pension Reserve Fund	2006	3.8	1.9	12.2
Mexico	IMSS Reserve	n.d.	3.6	0.3	-6.7
Poland	Demographic Reserve Fund	2002	3.4	0.7	39.1
Total selected OECD countries (3)			*4,776.5*	*19.9*	*5.0*
Other major economies					
Saudi Arabia	General Organisation for Social Insurance (1,4)	1969	400.0	106.4	n.d.
China	National Social Security Fund	2001	126.5	2.2	10.3
Argentina	Sustainability Guarantee Fund	2007	45.7	12.3	26.4
Total other major economies (3)			*572.2*	*75.9*	*14.6*
Memo item: Sovereign Wealth Funds with a pension focus (5)					
Norway	Government Pension Fund - Global	1990	509.1	122.8	16.6
Russian Federation	National Wealth Fund	2008	88.4	5.9	-2.7

Source: Pension Markets in Focus, July 2011

The trend around the world is for pension funds (not just reserve funds) to get larger and indeed government and regulatory authorities have been finding ways to encourage this trend. For example in the United States pension funds have been working together to gain economies of scale, whilst in Canada and the Netherlands large funds (such as OMERS in Canada and PGGM in the Netherlands) are now allowed to compete for external assignments. Centralizing is coming to the UK with the introduction of the NEST (National Employment Savings Trust) system, whilst in Australia the licensing of trustees caused the number of superannuation funds to decline. It should also be noted that mandatory systems in countries with less developed capital markets (such as in Latin American and Eastern Europe) operate with only a handful of large funds.

As a percentage of stock market capitalisation, the AP funds in combination represent a relatively large level of stock market capitalisation which would highlight the importance of international diversification to their portfolios to reduce their potential dominance on the Swedish markets. The AP funds are, however, significantly smaller when compared to the relative size of some of the other reserve funds around the world (notably the Irish and the Asian pension reserve funds).

Figure 1. Size of public pension reserve fund markets in selected OECD countries and other major economies, vs. Stock Market Capitalization 2010



Source: OECD Global Pension Statistics and the World Federation of Exchanges

Other public pension reserve funds have found different ways to reduce their potential market impact. For example, the Norwegian reserve fund has, for example, split its fund into a domestic and an international component in order to reduce market impact.

Meanwhile, in the United States Social Security Trust Fund has invested exclusively in US Treasury obligations backed by the full faith and credit of the US government. Some critics, however, have questioned whether this funding from within the US government for US government obligations amounts to true additional security for pensioners (Buffin Partners, 2011).

The Level of Costs

In 2010, the OECD received self-reported data on operating costs from AP 1, 3 and 4 as well as from pension reserve funds in some other countries. Based on the data received, the operating costs of the AP funds appear to be in the middle of the range compared to the operating costs of public pension reserve funds in other OECD countries.

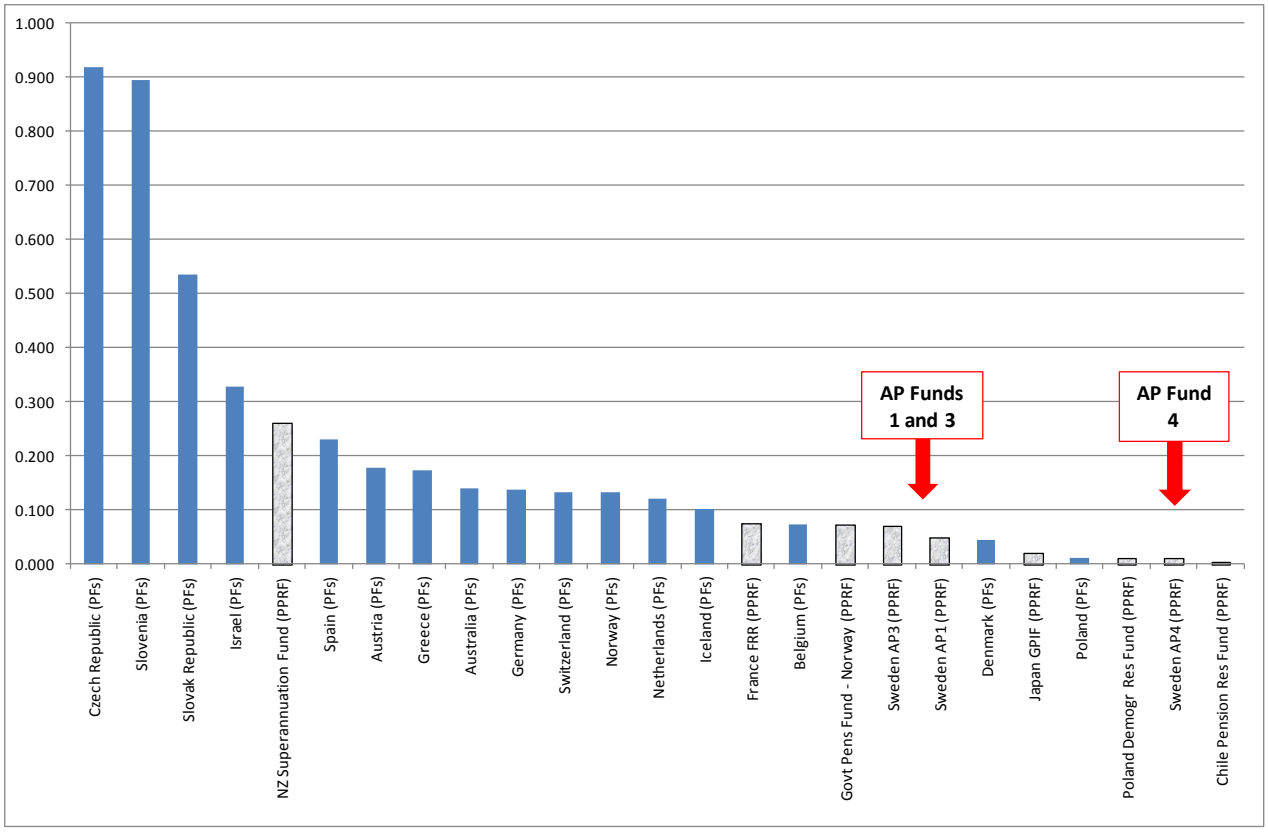
In 2010, the Swedish AP funds had lower total operating costs as a percent of total assets than the larger funds in the United States and France and a higher percentage of operating costs compared to some of the smaller funds. The New Zealand superannuation fund has higher expenses, This may be to some extent explained by the small size of the New Zealand pension reserve fund and hence less economies of scale. Also, the New Zealand pension reserve fund invests relatively heavily in private equity and hedge funds which can be expensive (OECD Pension Markets in Focus, July 2011).

It is important to note, however, that comparing operating costs across countries can be difficult given different reporting methods and the variety of roles that funds play in various countries (for example the Canadian fund reports net investment returns and does not disclosure investment expenses separately). Therefore, these numbers can only be considered as a broad indicator of differences in cost across countries.

The OECD also keeps statistics on investment management costs. If the total investment management costs of traditional pension funds over their aggregate assets across countries were compared to the investment management costs of the AP funds and other pension reserve funds, then the AP funds would be on the lower end of this comparison in 2010 (together with the majority of the pension reserve funds). The lower level of investment management costs would make sense given the typically larger size of public pension reserve funds compared to traditional pension funds and associated economies of scale.

It should be noted that Sweden's occupational defined contribution pension system is lauded internationally for being a very low-cost system, so there may be areas where good practices from the occupational pension system could be shared. It is important to note that investment management cost data is often underreported due to difficulties in identifying fees in certain types of investments. The data shown in Figure 3 has not been audited and should be viewed as a broad comparison only.

Figure 2. Total pension funds and pension reserve funds' investment management costs in selected OECD countries, 2010 (as a % of assets under management)



Source: OECD Global Pension Statistics

In 2010, the costs associated with administration of the AP funds in total was SEK 820 million, divided roughly equally among them. Based on the 2009 review of the AP funds by the Swedish government, the level of administrative costs over the total fund assets has been roughly around ten basis points since 2005, whereas it was over twice that level the two years prior.

It should be noted that the 2010 administrative costs of the AP 6 was approximately level with the administrative costs of the other AP funds in terms of SEK spent, despite its assets being roughly one-tenth the size of the other funds. This would place the AP 6 fund on the high end of operating costs as a percentage of total assets on an international basis. However the unlisted, direct nature of the investment of AP6 inevitably makes it more expensive to run. It should be noted that the New Zealand pension reserve fund is small and invests more heavily in private equity and hedge funds compared to other funds and it also has relatively high operating costs.

The issue has been raised in the previous 2009 AP Fund review and elsewhere whether the costs of the AP funds could be reduced if they were consolidated due to economies of scale. Keith Ambachtsheer at the International Centre for Pensions Management (ICPM) has done extensive research on the relationship between pension fund size, governance and performance[2]. A 2011 study by Dyck and Pomorski found that the largest funds included in their study outperformed smaller funds on the order of 43-50 basis points per annum.

To summarise, given that the AP funds 1 to 4 do not have excessive operating costs on an international basis if measured as a percentage of fund assets, and have in fact a lower cost measure than some significantly large public pension reserve funds, the basis for further cost reduction may not be major. Furthermore, given that the costs do not appear to be excessive by international standards, the performance measure of the funds made in the current and future reviews could arguably focus more on the performance of the funds against their long-term objectives as well as the long-term net investment return, and consider operating costs as a complementary, rather than as a primary performance criteria.[3]

Finally, it should be noted that the OECD has not reviewed the remuneration policies of the AP Funds in depth, but they appear to follow good practice. That said, such policies should work to promote performance in alignment with the long-term investment goals of the funds (for example basing the measurement of any performance related pay over several years). Remuneration policies should be careful not to reward short-term performance to the detriment of the long-term objectives of the funds.

Political Interference

Political pressure and interference of public pension reserves remains a high risk around the world, especially in times of economic stress. A structure of multiple, independent funds is a compelling approach to addressing this risk as well as the risk of concentrating too much power in a few hands. On the other hand, the visibility of one large, properly governed and independent fund may serve as greater protection to outside interference as compared to the relative anonymity of several smaller funds. That said, measuring the effectiveness of various approaches to mitigating political risk is quite difficult given the numerous shapes such risk can take. Given that the assets in a pension reserve fund ultimately belong to current and future pensioners, the funds and their management should ultimately be answerable to a country's electorate which means they can never be fully independent of the political process.

[2] See research at www.rijpm.com/research_paper/research-papers

[3] The government's annual evaluation of the AP-funds and the performance of AP1-4 and AP6 are evaluated based on the 'income index' and the goals set by each of the AP-funds.

It is important to note, however, that susceptibility to political pressure does not have to be correlated to the number of funds. The very public nature of the funds' mission and the large amounts of money involved can make them an inviting target. Furthermore, the line between decisions made based on political and investment considerations is not always fully distinct. For example, during the financial crisis in early 2009, the Irish parliament directed the Irish pension reserve fund assets to invest in two ailing banks.[4] Proponents said this was a decision based on investment considerations, whereas critics argued that it was a misuse of the funds' assets. Another example of a significant change in a reserve fund's mandate during the crisis was in France where the government moved the date of the first payout from the pension reserve fund from the original scheduled date in 2020 to immediate payments as of 2011.[5] Political considerations could also come into play is when investment decisions are made based on "ethical" grounds. Defining what is ethical and what is not and to what extent such investment decisions favour a particular political agenda over providing the highest pensions possible to current and future beneficiaries can be difficult to establish.

In 2009, the government issued a directive asking the AP funds to use their ownership rights in Swedish companies to help align the companies' compensation policies with the government's guidelines (Regerinskansliet, 2009). This directive raised the question as to what extent the decision-making power of the AP funds is independent of the government, and to what extent it should be independent. The government has since clarified that the AP funds are independent in their exercise of voting rights.[6]

To summarize, political interference and the concentration of power remains a risk in many countries, especially during times of economic uncertainty. Proper governance, transparency and disclosure and appropriate levels of risk control and supervision can mitigate, but not altogether eliminate this risk. Governance and oversight are further discussed in the governance section of this paper, found below.

[4] See http://www.nprf.ie/InvestmentStrategy/investmentStrategy.htm.

[5] See http://www.fondsdereserve.fr/spip.php?article511.

[6] This issue has been evaluated by the Parliament in relation to guidelines to the AP-funds on remuneration issued by the Government (see report 'Konsitutionssutskottets betankande' 2009/20:KU20).

INVESTMENT FRAMEWORK

Mandate and High-Level Objectives: AP funds 1 to 4

The mandate of the Swedish AP funds 1 to 4 as defined by law is to "manage fund assets in such a manner so as to achieve the greatest possible return on the income-based retirement pension insurance. The total risk level of the investments made by the Funds must be low."[7] In addition, the funds must be able to transfer funds to the Swedish Pensions Agency as required.

This type of over-arching mandate describing the ultimate purpose of the AP funds is typical for pension reserve funds. Given that this over-arching mandate tends to be quite broad, the government or the governing board of national pension reserve funds must furthermore interpret their mandate in order to set their long-term investment objectives. The long-term investment objective guides the funds in fulfilling their mandates by providing more specific long-term targets for the funds' investments, and would also ideally provide some type of guidance, structure or benchmark against which the funds' performance could be objectively measured. Pension reserve funds such as the Canada Pension Plan and the New Zealand Superannuation Fund have expressed their long-term investment objectives in a transparent, targeted and measurable manner, whereas some other pension reserve funds' long-term investment objectives are more vague in their formulation.

Table 2. Mandates and Investment Objectives of Public Pension Reserve Funds

Reserve Fund	Objective
CPP Canada	The mandate of the CPP is "To invest in the best interest of Canada Pension Plan contributors and beneficiaries and to maximize investment returns without undue risk of loss." (Source: http://www.cppib.ca/About_Us/) The fund is expected to cover 20-25% of the projected value of accrued benefits for current contributors and beneficiaries. Based on the most recent tri-annual sustainability review made by the Chief Actuary of Canada, given the current rate of contributions to the system, the fund's annual investments will need to earn a 4% real rate of return, net of expenses, over the review's 75-year horizon. Source: CPP Investment Board 2011 Annual Report
FRR France	"The Fund is being established for the purpose of managing the sums that are allocated to it in order to build up reserves intended to contribute to the long-term sustainability of PAYGO pension plans. The FRR then determines the general investment policy based on "the principles of caution and diversification of risks in line with the objectives and timeframe for utilisation of the Fund's resources". (Source: FRR Foundational Texts) The investment objectives of the FRR were significantly changed by pension reforms made in 2010. Before the change, the FRR had been expected to have cash outflows between 2020 and 2040. After the reform, the cash outflows will instead have to be made much sooner, between 2011 and 2024. Source: http://www.fondsdereserve.fr/spip.php?article512

[7] From the English translation provided by the Buffer Fund Inquiry of the National Pension Insurance Funds Act, "Lag (2000:192) om allmänna pensionsfonder (AP-fonder)".

<table>
<tr><td>National Pension Reserve Fund Ireland</td><td>The mission statement of the Commission (the governing board) as adopted in 2001 is:

“To meet as much as possible, within prudent risk parameters to be agreed by the Commission, of the cost to the Exchequer of social welfare and public service pensions to be paid from the year 2025 until the year 2055, as provided for in the National Pensions Reserve Fund Act, 2000.”

In March 2010, the mission statement was amended to include the following supplementary objective:

“to outperform the cost of five year government debt over rolling five year periods at a 75% probability level.”

Source: http://www.nprf.ie/InvestmentStrategy/investmentStrategy.htm</td></tr>
<tr><td>GPIF Japan</td><td>The mandate of the GPIF in Japan is to invest the assets so as to contribute to the long-term financing of public pension expenditures.

The long-term performance goal is set by the Ministry of Health and Welfare. The target, long-term rate of return should be sufficient to maintain a stable ratio of reserves to annual public pension expenditure. The long-term real rate of return target is currently 1.1% p.a. above the rate of nominal wage increase.</td></tr>
<tr><td>National Pension Fund Korea</td><td>The National Pension Fund of Korea’s mandate is “maintaining and increasing the value of the fund in order to achieve the long-term stability of the fund.”

The fund’s investment policy statement defines a long-term goal to align its return with the pace of GDP growth.

Measureable objectives are set out in the Fund Management Guidelines, which are determined by the Management Committee. These are real economic growth plus CPI growth rate plus an adjustment factor determined by risk tolerance level which is set by a 5 year risk shortfall of 10% (i.e. risk of 5-year accumulated return being less than 5-year accumulated CPI).</td></tr>
<tr><td>New Zealand Superannuation Fund</td><td>The mandate of the governing board (the “Guardians”) is stated in the New Zealand Superannuation and Retirement Income Act 2001:

The Guardians must invest the Fund on a prudent, commercial basis and, in doing so, must manage and administer the Fund in a manner consistent with

(a) best-practice portfolio management; and

(b) maximising return without undue risk to the Fund as a whole; and

(c) avoiding prejudice to New Zealand’s reputation as a responsible member of the world community.

No capital withdrawal is allowed from the Fund in any financial year commencing before 1 July 2020, although according to the Fund’s 2011 annual report, withdrawals are not expected to be made until 2031.

The Guardians must develop and comply with their “Statement of Investment Policies, Standards and Procedures”. As of 2011, this statement requires the fund’s investment return:

(i) to exceed the compound New Zealand Treasury Bill over rolling 20 year periods; and,
(ii) to exceed the benchmark return for the Reference Portfolio which is comprised of simple, low-cost, passive exposures, as follows:

<table><tr><th>Asset Class</th><th>Percentage of Reference Portfolio</th></tr><tr><td>Global equities</td><td>70%</td></tr><tr><td>NZ equities</td><td>5%</td></tr><tr><td>Global listed property</td><td>5%</td></tr><tr><td>Total Growth</td><td>80%</td></tr><tr><td>Total Fixed Interest</td><td>20%</td></tr><tr><td>TOTAL</td><td>100%</td></tr></table></td></tr>
</table>

Norway Government Pension Fund Global	According to the Government Pension Fund Act of 2005, the mandate of Norway's Government Pension Fund Global is to "support government saving to finance the National Insurance Scheme's expenditure on pensions and support long-term considerations in the use of petroleum revenues." The fund is not strictly intended to finance pension expenditures and the fund has no formal pension obligations. Norges Bank Executive Board manages the fund and according to their website (www.nbim.no), no political decision has been made as to when the fund may be used to pay pension costs. The Ministry of Finance sets the investment strategy for the fund with the goal of generating the highest possible return with moderate risk, as follows: "Responsible management of the fund shall safeguard and build financial wealth for future generations. The Ministry of Finance has decided that 60 percent of the fund shall be invested in equities, 35–40 percent in fixed-income securities and as much as 5 percent in real estate. All the fund's investments shall be outside Norway." Source: http://www.nbim.no/en/About-us/faq/

The interpretation of the AP funds' over-arching mandate and the establishing of a high-level investment objective is done by each of the four AP funds independently. In practice, this has translated into four very distinct long-term investment objectives for AP Funds 1 through 4, subject to strict investment restrictions codified by law. The lack of a coordinated and targeted investment objective for all of the AP funds and the lack of a concrete and common long-term performance measure has led the funds to mainly benchmark their performance against each other. The establishment of an overarching and specific investment objective against which long-term performance can be measured is essential.

The interpretation of the over-arching mandate by the four AP funds as expressed in their investment objectives of are as follows (as defined in their 2010 annual reports):

Table 3. Current Investment Objectives of AP Funds 1 to 4

	AP1	AP2	AP3	AP4
Objective	5.5% nominal return after costs over a rolling 5-year period	Average annual real rate of return of 5%. Per an interview with AP2, this target has been determined to minimize the risk of the balancing mechanism being activated over a 30-year period.	A long-term real-return of 4%.	Average annual real rate of return of 4.5%.

Source: Interviews with the AP funds and the 2010 Annual Reports of AP Funds 1 to 4

The over-arching mandate of the AP funds established in the law does make some reference to pension liabilities and the role which the AP funds are expected to play in the pension system as a whole (i.e. asset allocation should be based on analysis of the liability side of the pension system) – but the link could be made clearer and more specific. According to the 2010 annual report of the pension system, the pension system's total liabilities are currently funded by about 12% by the assets of the AP funds 1 to 4 and 6. The remaining 88% of the pension system's total liabilities are expected to be funded by future social security contributions made by Swedish workers. Any funding shortfall would mean that the so-

called "balancing mechanism" [8] would be implemented and pension benefits would be adjusted downward accordingly (Pensionsmyndigheten, 2010). The balancing mechanism was established to help keep the system financially in balance and to ensure a better balance between contributions into the system versus payments out between generations.

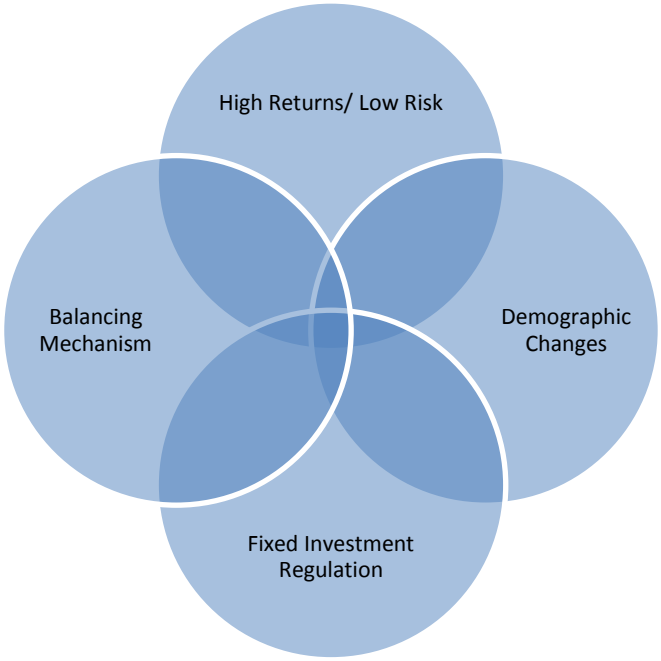
As of year-end 2010, the AP funds held SEK 895 billion - and this amount is expected to decline to SEK 400bn (corresponding to todays value of money) by 2040 (Ministry of Finance, 2011) due largely to demographic changes and pension benefits earned from the pre-2000 reformed public pension system. However, neither this pay out structure, nor the expected decline in the value of the AP funds, is made explicit in the high level objectives of the funds.

However, no reference is made to the fact that the performance of the AP funds has a direct impact on the payment of pension benefits, through the balancing mechanism. As these two factors are key elements of the purpose and functioning of the buffer funds they should be more explicitly included in the high-level, over-arching objective of the funds. Furthermore, the level of acceptable risk that the balancing mechanism be implemented and benefits cut, and the associated social, financial and political implications that this would entail, should be directly taken into account when establishing the long-term return versus risk target.

It is interesting to note that the internal asset liability management (ALM) models of the AP funds have led them to the current and rather ambitious investment return targets – which they have not been able to meet, on average, over the past 10 years. To illustrate the somewhat conflicting considerations that come into play, if the investment objective of the AP funds over the long-term is to maintain or improve the current 12% funding level of the pension system balance sheet, then this could imply that the funds take on a high level of risk in order to achieve high long-term returns (particularly if the total, underfunded level of the pension system as a whole in taken into account – which is driving the high investment return targets which the funds have set themselves). However, if the main objective of the funds is to minimize the risk of the balancing mechanism being triggered, then this would seem to imply a much lower level of risk. Given these considerations and the contradicting impacts they could have on the strategic asset allocations of the funds, the role that the funds are expected to play in the pension system as a whole and their ultimate goals with respect to funding levels, the balancing mechanism, and buffering the impact of demographic changes should be clarified.

[8] If the assets of the pension system (the buffer fund plus the estimated value of assets in the form of contribution revenues) fall below the liabilities (accrued notional pension capital and capital value of outgoing pensions), then indexation of pensions in payment and returns credited to notional accounts are reduced by the ratio of assets to liabilities. The balance ratio for the year *t* is used to calculate the balance number or the need for activating the balancing mechanism in the year *t*+2. During a recovery period, which makes up for any reduction in benefits, pensions can be raised by more than inflation. See Swedish chapter of *OECD Pensions at a Glance*.

Figure 3. Considerations relating to AP Funds' Role in Swedish Pension System



The OECD recommends following the international good practice followed by, for example, the Canada Pension Plan and by the New Zealand Superannuation Fund. A clear high level investment objective in terms of a funding ratio, payout time and consequent real rate of return target should be put in place which is the same for all the funds. This should be established (and reviewed) by an independent body of experts answerable to Parliament (possibly a group that would also be responsible for setting performance measurement criteria, nominating board members, etc.). The funds should report to Parliament on their performance relative to these objectives.

It is extremely important that the objectives of the fund are set in law with parliamentary approval. The experience of other reserve and pension funds around the world in the wake of the financial and economic crisis has been that the long-term objectives of the funds have been overturned for shorter-term political needs. Clearly there needs to be a mechanism in place to review and alter the objectives of the fund as circumstances arise (changing demographic factors etc.) – but this needs to be balanced with proper independence and oversight to ensure that the funds are able to operate in order to fulfil the long-term goals of the pension system.

The monitoring of the funds should be done over a long-term basis in line with their long-term nature and investment targets. One consequence of having more than one fund is that the individual funds' investment performance tends to be regularly compared to each other rather than to the overall goal of funding the public pension system. One advantage of multiple funds is that this system promotes competition among the funds, and introduces some diversification in terms of the asset liability management (ALM) processes and models used. However, a potential consequence is that herd-like investment behaviour may also be encouraged.

Investment Policy

The OECD guidelines note that the governing body of a pension fund should set forth in a written statement and actively observe an overall investment policy.

As a minimum, the policy should cover:

- How the fund intends to achieve the over-arching investment mandate of the funds;
- The strategic asset allocation (main asset classes);
- The extent to which external managers may be used and how they are to be selected and monitored;
- To what extent and how active investment management will be pursued; and
- The criteria for assessing the performance of the reserve fund and the different portfolio components.

This is even more important for reserve funds. Reserve funds, like pension funds, require a clear mission statement and measurable objectives to enhance their efficient management and raise the accountability of the governing body. Reserve funds do not normally have national competitors or even peers, as is the case with pension funds. Hence, their performance (including not just investment performance but also their operational efficiency) can only be benchmarked against any initial objectives set or, as far as relevant, against foreign reserve funds. Furthermore, reserve funds support pension systems that do not typically have a full-funding goal in mind. Therefore, investment objectives may not always be readily established with regards to liabilities, time horizon or risk aversion. Reserve funds should have clear mandates and specific measurable objectives, such as a funding ratio and investment return targets. The performance of the board should be measured against these objectives.

OECD guidelines note that the strategic asset allocation of a pension fund should be put in place to deliver the investment objectives of the fund. The asset allocation should be set in the statement of investment policy and there should be a process for a regular review of that policy by the governing board, at least every three years.

The setting of restrictions on broad asset classes should be left to the board of the reserve fund as part of the design of the investment policy**.**

The AP funds broadly comply with the OECD recommendations in terms of their investment policies. The issue is that, as discussed above, the overall investment objective set by the AP legislation is so broad that the fund's investment policies effectively have become their long-term investment objectives. In other words, the funds are effectively setting their own long-term investment objectives independently of each other which in our view does not altogether align with international good practice.

Prudent Person Rule

The *OECD Guidelines on Pension Fund Asset Management* support the use of the prudent person rule to meet a fund's investment objectives. This would also be the general recommendation for pension reserve funds. The guidelines do acknowledge that investment limits can also be used, providing they are consistent with this policy and do not inhibit adequate diversification or impede the use of asset-liability matching techniques. Reserve funds usually face additional restrictions intended to ensure diversification or to avoid direct control of corporations. Given the high level of expertise and strong risk-management functions in place at the AP funds, there does not seem to be any reason to believe that the application of the prudent person rule would expose the reserve funds to undue risk.

If risk control is seen as an issue and considered a motivation for not implementing the prudent person rule, then oversight of the funds by an external supervisory body (such as the authority which oversees private pension funds) could be put in place. Indeed, the OECD would recommend such a move whatever the structure and investment backdrop for the funds. If the regulation is designed to address the issue of the potential market impact of the funds, this can be dealt with in other ways than via investment restrictions (as discussed below).

The previous OECD review of public pension reserve funds noted that the investment rules for the Swedish funds were potentially restrictive (Yermo, 2008). The following restrictions by asset class have been applied since 2001:

- Only investments in capital market instruments which are quoted and marketable are permitted. Direct loans are prohibited.
- No more than 5% of the funds' assets may be invested in unlisted securities. These investments must be made indirectly via portfolio management funds or similar.
- At least 30% of the funds' assets must be invested in low-risk, interest-bearing securities.
- No more than 40% of assets may be exposed to currency exchange risk.

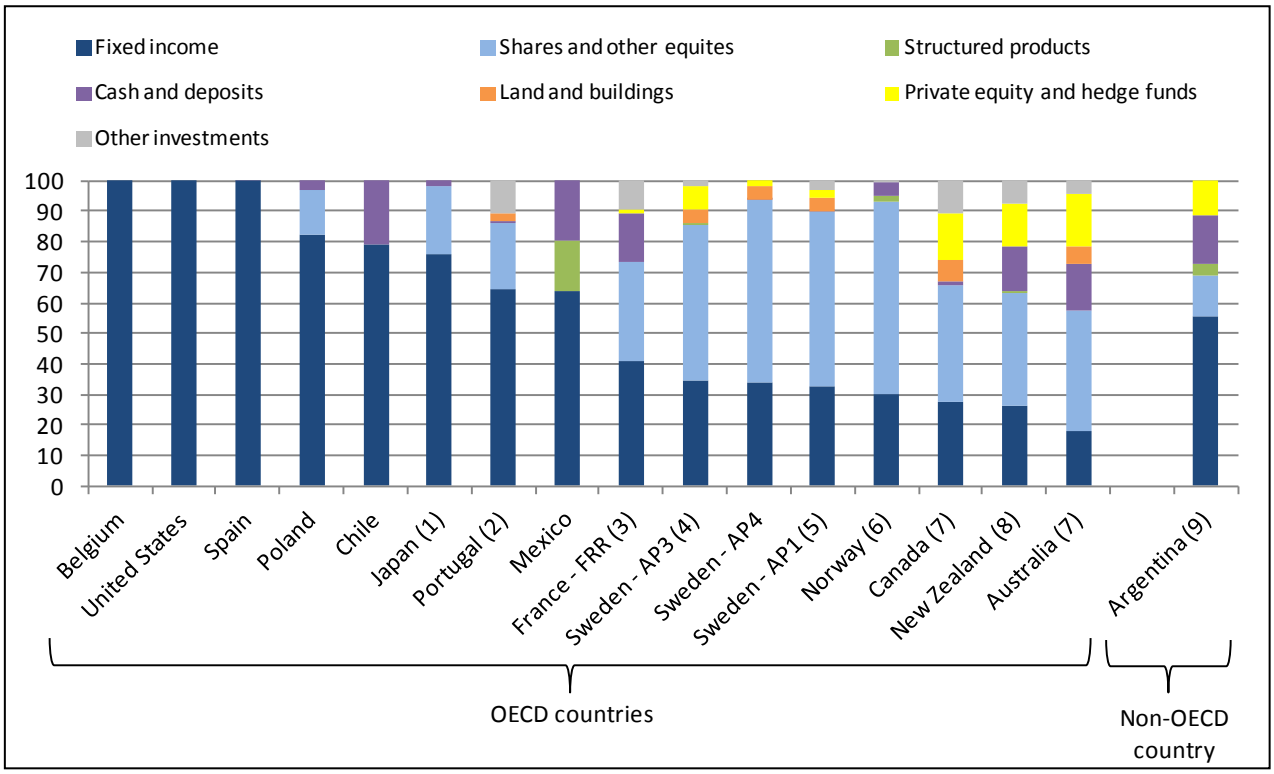
The funds also cannot invest in commodities.

Regulations also apply which are intended to ensure diversification or to avoid direct control of corporations by reserve funds.

- No more than 10% of a fund's assets may be exposed to one issuer or group of issuers.
- Shares held in listed Swedish corporations may not exceed 2% of total market value.
- Each fund may not own more than 10% of the votes of any single listed company.

These investment rules are more restrictive than other reserve funds - with major investment limitations only being in place in Ireland, Japan and Korea (see Yermo 2008). The requirement that at least 30% of the funds' assets must be invested in low-risk, interest bearing securities does not comply with the *OECD Guidelines on Pension Fund Asset Management*, which do not recommend any floors on asset classes as these can distort markets. This restriction was put in place when private pension funds in Sweden were subject to similar investment regulation restrictions. However, these funds are now regulated by the prudent person rule, and there does not seem to be any reason why the AP funds should therefore continue to be bound by this rule – which they find restrictive, and could lead to suboptimal portfolios and potential over-exposure to certain types of unrestricted assets. The investment restrictions mean that the diversification of the AP funds is less than some of their international counterparts, although they are more diversified than others.

Figure 4. Asset allocation of public pension reserve funds in selected OECD and non-OECD countries, 2010



Source: OECD Global Pension Statistics

Furthermore, restrictive investment regulation works to undermine the purpose of having four independent and competing buffer funds. The investment regulations restrict how the funds can construct their portfolios, which end up looking fairly similar, taking away some of the potential benefits of competition and diversification.

That said, the restrictions on over-exposure to a single issuer, voting rights of a listed company or the Swedish domestic market would seem more appropriate to maintain. These types of restrictions are common in jurisdictions that implement the prudent person rule (OECD, 2006).

At least 10% of the AP assets must be managed by external fund administrators – to fulfil the government's wish to isolate funds from political pressure. The OECD do not make specific recommendations on the issue of internal vs. external management, but notes that the increasing scale of pension funds around the world has allowed the leading funds to build their internal resources, capacity and expertise. Combining the AP funds or sharing certain functions may also allow them more scope to build centres of expertise in various investment categories and to invest in assets which require knowledge and scale (such as direct infrastructure investments, such as the leading Canadian funds are making).

The Sixth AP Fund

The AP Fund 6 is governed by a separate law from AP funds 1 to 4. AP6 pays out no benefits and receives no contributions and has approximately one-tenth the assets of each of the other four AP funds. The AP6 fund's mandate is to, within the framework of what is in the interest of the pension system, invest

its assets in Swedish private equity.[9] According to its website, the AP6 fund invests in unlisted small and medium growth companies, either directly or indirectly through funds.

The OECD has made no review as to the need for funding in the Swedish private equity or venture capital markets. Unlisted assets and other alternative investments such as infrastructure, both domestic and foreign, can be an important investment class for pension funds. However, the role of the AP6 fund within the pension system should be clarified. Furthermore, the decision as to which companies and projects to invest in and to what extent such investments are made should be made transparent and objective and be tied directly to the goal of providing the highest possible return. Otherwise, there is a large risk that such decisions could be at least perceived to raise questions of independence and conflicts of interest. Furthermore, the performance of the AP 6 fund and the level of its operating costs in relation to its level of assets should be directly measured in relation to its contribution to the overall goal of providing the highest possible return given the level of acceptable risk for the ultimate beneficiaries of the Swedish pension system.

It is the understanding of the OECD that the executive team which took over the management of the AP6 fund in recent years does run the fund within the broader interests of the pension system. However, for future clarity, the mandate of the AP6 fund should clarify that its investments must be motivated by the best interest of the pension system, in line with the mandate for the other AP funds. Investment in unlisted assets takes expertise and specialisation which would argue for maintaining AP6 as an entity. One potential solution may be to embed the AP6 fund and its private equity exposure within the other AP funds. Merging or embedding AP6 within the other AP funds may improve the transparency and governance of such private equity investments and clarify the mandate.

Furthermore, should the other AP funds wish to make a strategic decision to invest in, for example, Swedish start-up companies or buy-out funds, then they would be free to do so under the prudent person rule as long as such investments are in the best interest of the pension systems' beneficiaries, fit within their investment mandate, make sense in terms of their broader asset allocation strategy and are duly approved by the governance board. In other words, the decision to invest in the Swedish private equity market should be made in the exact same manner as any other investment decision made by the AP funds.

To summarise, if the AP 6 fund is to be maintained, then its mandate should be clarified and aligned with the best interest of the pension system. Also, the need for investment in private equity should be formally expressed and aligned with the overall investment mandate of the AP funds, should be made consistent with the broader strategic asset allocations of the AP funds, and should not be limited to the domestic market. Furthermore, should the Swedish Parliament decide that specific financing for the domestic private equity market is a priority to be maintained, then there may be an argument for doing this independently and without any ties to the state pension system whatsoever.

[9] See the law 2000:193 on the Sixth AP Fund.

GOVERNANCE ISSUES

In terms of the governance of these funds, the OECD notes that the main feature of public pension reserve funds is that their ultimate beneficiaries do not have legal or beneficial ownership over the fund's assets – leaving them potentially exposed to state influence (particular as may lack oversight body/ clear objectives/ peer comparisons).

The OECD *Guidelines on Pension Fund Governance*[10] also apply to reserve funds – but they need additional safeguards to promote better protection from political manipulation – in particular special care over the appointment of the board (which usually contains government representatives). It should be noted that proper governance can mitigate the risk of political interference - though public pension reserve funds and pension funds can remain exposed to such interference especially in times of economic distress.

The AP funds appear to have highly experienced management teams in place, including at the CIO and CEO level. The internal running of the funds is not seen as an issue by the OECD based on our high-level review. Remuneration does not appear to be excessive and is subject to government guidelines. The prestige of the positions and salaries that are broadly competitive with the industry appear to make it possible for the AP funds to recruit high quality staff. One issue which may need to be clarified if the funds were to move to a more prudent person investment approach is performance related pay. This should be measured over a multi-year period, with no one year having an excessive impact, and caps on variable vs. fixed remuneration could be set. This would follow the good practice of other international funds, such as those in Canadian and New Zealand, for example. [11]

Overall, the AP funds generally appear to follow OECD governance recommendations, such as the requirement for independent audit and oversight. The risk-management systems of the funds appear to be well organized (for example with a Chief Risk Office reporting directly to the Board[12]).

The selection process for the governing board, however, could be made more transparent and rigorous, as discussed below.

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[10] See *OECD Guidelines for Pension Fund Governance* at www.oecd.org/daf/pensions. The guidelines cover issues such as the governing board, the role of accountants and actuaries, reporting and disclosure.

[11] The bonus structure and limits for the New Zealand superannuation fund are outlined in the annual report – see http://www.nzsuperfund.co.nz/files/Annual%20Report%20with%20bookmarks.pdf. There are 3 bonus groups within the staff with different ceilings on their performance related pay (investment team 60% of base pay, executive team 40%, and support staff 20%). For the investment and executive team, half of the bonus is paid annually based on the individual key performance indicators, and the other half is based on a 4 year moving average of the fund's performance (half absolute and half value-add return). The support staff 20 per cent bonus is paid annually purely on key performance indicators being achieved.

The CPPIB in Canada note in their annual report that majority of total pay is incentive based – see http://www.cppib.ca/files/PDF/CPPIB_AR_2011_EN_Online.pdf. In the case of senior investment professional, a higher percentage of their compensation is tied to four-year investment performance (target 53%, maximum 64% of total compensation for the CEO, CIO), whilst with non-investment professionals a higher percentage is comprised of base salary and tied to individual objectives.

[12] This is one recommendation made in the *OECD Good Practices for Pension Funds' Risk-management Systems* at www.oecd.org/daf/pensions.

Autonomy of the Governing Body

As the OECD guidelines point out, the governing body of the pension fund is the key body in governance terms. The governing body is the central strategic decision-making organ of a reserve fund. Its main function is approving the investment policy for the fund, and specifically, the strategic asset allocation. The governing body also monitors the executive and operational staff of the fund and is responsible for fulfilling the fund‘s mission and complying with regulations. Given the critical importance of the governing body, it is understandable that efforts at insulating reserve funds from political risk have focused on this. The role of the governing body is even more important for public pension funds and especially for reserve funds as they are usually the single players in the sector and hence they cannot readily be compared against their national peers, as is often done with private pension funds (though one can, however, compare reserve funds across countries, as is done in this paper). A strong, qualified board of directors, as far removed as possible from political influence, is therefore an essential feature of a well-governed reserve fund.

The OECD finds that a segregated and independent governing body that is established expressly for overseeing a pension reserve fund is preferable as a protection against political interference, especially if a government ministry is responsible for administering the pension system’s benefits. In practice, however, the governing body of a reserve fund may also be a government ministry or the board of the social security institution.

Furthermore, ideally reserve funds should be served operationally by an autonomous management entity, dedicated exclusively to the administration and investment of the reserve fund assets.

Sweden, along with Canada, France, Ireland and New Zealand follow this approach preferred by the OECD.

The approach taken by a number of countries to management and governance is described below.

Table 4. Management entities and governing bodies of reserve funds

Country	Management Entity	Governing Body
Canada	Canada Pension Plan (CPP) Investment Board (a public sector corporation)	Board of Directors of the CPP Investment Board
France	Pension Reserve Fund (FRR)	Supervisory Board of the FRR
Ireland	National Treasury Management Agency	National Pensions Reserve Fund Commission
Japan	Government Pension Investment Fund (GPIF)	Chairman of the GPIF and the Ministry of Health, Labour and Welfare
Korea	Fund Management Centre of the National Pension Service (the country’s social security institution)	National Assembly
New Zealand	Guardians of New Zealand Superannuation (a public sector corporation)	Board of the Guardians of New Zealand Superannuation
Norway	Norges Bank Investment Management (an arm of the Central Bank) for the “Global” fund and “Folektrygdfondet” (National Insurance Fund) for the “Norway” fund	Norwegian Parliament and the Ministry of Finance

Source: Yermo, 2008, “Governance and Investment of Public Pension Reserve Funds in Selected OECD Countries

Membership and Selection of the Governing Body

As the ultimate authority with responsibility for the management of the reserve fund, the composition and functioning of the governing body are the first and main determinant of the fund's performance. An experienced, well-functioning board will ensure that proper monitoring, incentive and control mechanisms are put into place to achieve the fund's objectives.

The OECD governance guidelines note that the membership of the governing body of a pension fund should be subject to minimum suitability (or non-suitability) standards in order to ensure a high level of integrity, competence, expertise and professionalism in the governance of the pension fund. Furthermore, the governing body should collectively have the necessary skills and knowledge to oversee all the functions performed by a pension fund, and to monitor those delegates and advisors to who such functions have been delegated. While it may not be necessary for all board members to be experts in finance, the board must collectively possess the necessary skills to carry out is oversight function effectively.

Special care needs to be taken with the selection and appointment of the board of reserve funds, given the potential for political interference and the appointment of directors to serve largely as representatives of specific stakeholders[13]. The role of independent directors appears to be even more needed than in private pension funds.

The size of the board is also important. Though it should reflect the nature and scope of the organization, if too large, efficient decision making can be impeded. Board members should be appointed following a transparent selection and nomination process. While the government often appoints directors to represent non-government interests, it is likely that the influence that the government has on their nomination process seriously limits the ability of the appointed directors to independently execute their functions. One way to reduce the direct influence of government in the appointment of directors and reduce the scope for cronyism is to establish a nominating committee of experts (selected by the government) who in turn nominate the directors of the reserve fund following a transparent recruitment process. This appointment structure is followed by the Canadian and New Zealand reserve funds.

Termination clauses are also important to avoid the capricious dismissal of members of the governing body by government.

Table 5. Summary of Board Nomination Process

Country	Fit and proper criteria	Nomination	Length of appointment	Removal
Canada	Directors are chosen based on financial experience and other criteria.	Directors are appointed by the Finance Minister from a list drawn by a nomination committee.	Directors have three-year terms for a maximum of three terms (9 years maximum).	Directors may only be removed for cause.
France	Two of the twenty members of the supervisory board must be individuals with recognized credentials in fields considered to be relevant to the FRR's stated missions.	Members are appointed by parliament (two), the senate (two), various Ministries (four), trade unions (five) and employer and self-employed associations (five).	Members that are not appointed by governmental authorities have 6 year terms.	

[13] Social security institutions usually have tripartite representation in their governing body (governments, employers and employees).

Ireland	Commissioners must have expertise and experience at senior level in any of the following areas: investment, economics, law, actuarial practice, civil service, trade union representation, etc. Civil servants cannot be Commissioners. A commissioner shall be disqualified from being a member of the Commission where he or she is bankrupt, is convicted of an offence involving fraud or dishonesty, or is disqualified or restricted from being a director of any company.	Commissioners are appointed by the Minister of Finance, except the CEO of the management entity, who is an ex-officio member of the Commission.	All Commissioners other than the CEO of the management entity have five year terms, renewable for a second consecutive term.	A commissioner may be removed by the Minister of Finance if the member has become incapable through ill-health of performing his or her functions, or has committed stated misbehaviour, or his or her removal appears to the Minister to be necessary for the effective performance by the Commission of its functions.
Japan	The Chairman and investment committee members must have experience in economic or financial matters.	The Chairman is appointed by the Ministry of Health, Labour, and Welfare.		
Korea	The national assembly is the main governing body.	Not applicable.	Not applicable.	Not applicable.
New Zealand	All board members must have experience, training and expertise in investment management.	Board members are appointed by the Ministry of Finance via a nominating committee.	Board members are appointed for up to 5 years.	Board members can be dismissed for reasons that in the Minister's opinion justifies the removal.
Norway	The governing body is parliament and the ministry of finance.	Not applicable.	Not applicable.	Not applicable.

Source: OECD Financial Market Trends 2008

Overall, the governance structure of the AP Funds appears to be strong and to follow OECD recommendations. Sound governance and risk-management structures appear to be in place, for example, with established codes of conduct, risk management committees, the chief executive officer and the chief risk officer reporting to the governing boards, internal and external audits, and regular reporting and disclosure.

That said, greater clarity could be given in terms of reporting lines to government. The pension reform that originally established the AP funds was the result of a compromise between the five main Swedish political parties, and any further major reforms would need to be driven by the parliamentary Pensions Group.

It is not entirely transparent which authority has ultimate responsibility for the pension system – given that the Swedish Pensions Agency (which administers benefits) is under the Department for Social Affairs,[14] where as the AP funds are under the Ministry of Finance and the (informal) parliamentary

[14] Though it should be noted that such public sector administration authorities have a fairly independent status in Sweden.

Pensions Group drives major reform. Furthermore, communication of the role and the importance of the AP funds in the Swedish pension system with the Swedish public seems to be quite limited. Greater public awareness as to the role of the AP funds may help build the public's confidence in the system. One idea that could be explored would be the establishment of an independent committee answerable to Parliament (potentially as a part of or an extension of the existing Pensions Group) that would be responsible for issues surrounding the AP funds such as objective setting, performance measurement, board member nominations and communication with the public.

In their previous report on public pension reserve systems (Yermo 2008), the OECD notes that one potential drawback of this segregated governance model practiced in Sweden is that investment management is separated from the actuarial and payments functions of the social security system. This separation may be impacting the AP funds and partly explain the lack of clarity in their goals and objectives (see previous discussion).

Governing Board Nominations

The board members of the AP funds are appointed by the government – which is standard practice for public pension reserve funds around the world. However, aside from the employer and employee nominated trustees, it is not clear how the board members are selected (indeed the process could be described as somewhat 'ad hoc').[15]

International good practice suggests that the independence of the AP Boards could be made more secure if an independent nomination committee (as discussed in the previous section) were responsible for selecting the Board members. This would allow for a more transparent and independent process. The nominations would be approved by Parliament rather than the government, again to ensure greater independence and stability, with the boards reporting to Parliament on an annual basis.

The Boards of the AP funds 1-4 in Sweden currently consist of nine representatives, including four elected following proposals from organisations representing employers and employees, withtwo nominations each (AP6 has 5 board members with no nomination from organisations). The Chair and Vice Chair are from the government nominees. This is not out of line with the size of the Boards of reserve funds in other countries (which range from seven in New Zealand and Ireland to twenty in France). In addition, several of the other Boards (such as in France) include representatives of employers and employees – which is not unreasonable provided that they have the appropriate skills and are approved by an independent nominating committee. Indeed these representatives (if appropriately selected) can bring a welcome broad perspective to the boards, representing Swedish society as a whole. Current law requires board members to have Swedish nationality.

The OECD has not made a detailed review of the skill level of the AP funds' board members, although it does appear as if the board members are, on balance, quite engaged and dedicated. In the interviews made with stakeholders, feedback was received that a handful of board members have strong investment experience, but on an overall basis, the level of investment experience on the boards could be augmented, which would give the boards greater capacity and credibility when discussing with and assessing the executives running the fund.

Based on our high-level review, there does appear to be some scope to strengthening the nominations process for the governing boards of the AP Funds, in particular to make the process more transparent and rigorous, following pre-defined selection criteria.

[15] There is an internal process within the government.

The selection criteria for the governing board members does not appear to be well-defined. The OECD would propose that overall requirements for experience and skills be defined on a collective basis for each fund and disclosed. Each individual board member would not need to meet all of the skills and experience required, but should complement the other board members, and as a whole, each board should meet the fit-and-proper criteria on a collective basis.[16]

A 'template' for the necessary skills for any board to have could be outlined by the independent nominating committee which proposes candidates, which would also help with the transparency of the selection process. The timeline and process for selection, as well as the reasons for which a board member can be removed from their position should also be clarified (for transparency and to further ensure independence from political interference). The Government has established a principle of approximately 8 years mandate period for a board member.[17]

In addition, given that there are four reserve funds, the number of suitable directors which have to be recruited is larger. Consolidating the funds together would allow for the appointment of one high level and highly experienced Board. It is currently not allowed to recruit foreign nationals as AP Board Members. This is not generally forbidden for the reserve funds in other countries. However, in order to attract the best possible candidates, this restriction should be lifted. This would seem more practical in Sweden than in some other countries given that language barriers are generally less of an issue. The Board Members of the AP funds are remunerated according to government policies, where as they serve on a voluntary basis in some countries – such as in France.[18] Given the prestige of such appointments, remuneration is unlikely to be the driving factor for candidates to sit on the AP Boards and therefore does not appear to be a major issue.

[16] This is consistent with the *OECD Guidelines for Pension Fund Governance* at www.oecd.org/daf/pensions.

[17] Skr.2010.2011:130 annex 1

[18] For reference, the CPPIB in Canada award their Board members an annual retainer of CAD$25,000 as well as CAD$1,500 or CAD $1,250 for board and committee meetings. Committee chairs receive a retainer of $7,500 and the chair of the board receives a flat remuneration of CAD$120,000. See www.cppib.ca

Board members of the New Zealand superannuation fund are paid a retainer of NZ$27,000, with Chairs receiving NZ$54,000 and Deputies NZ$33,700. See www.nzsuperfund.co.nz

CONCLUSION

In summary, the OECD proposes that a consistent, clear and measurable objective with a long-term horizon be implemented for all the AP funds. This objective should be approved by the Swedish parliament and regularly reviewed. It could be expressed in terms of the expected timing and size of the pension system's cash-flows, the long-term funding target of the AP funds in relation to the pension system's liabilities and the acceptable risk/return trade-off. The performance of the AP funds should be measured primarily against this long-term objective.

The investment regulations for the funds should be based on the prudent person principle, with oversight by an independent supervisory authority.

The Inquiry should also consider the position of the AP6 fund. The Inquiry may wish to further consider whether the AP6 Fund's current private equity mandate be maintained and, if so, how to make its investment decisions transparent. If providing funding to the domestic private equity market remains a political priority, consideration could be made as to whether the AP 6 fund should be separated completely from the pension system.

The extent to which the decision-making powers of the AP funds are independent from the government should be confirmed. More clear reporting lines could also be established within the government, potentially with an independent committee answerable to Parliament as the "owner" of issues relating to the AP funds such as nominating board members, setting the overall objective of the funds, establishing performance measurement criteria and communicating the role of the funds to the Swedish public.

To help ensure independence, the board members of the Funds should be nominated by this independent committee, and the nominees should be confirmed by Parliament. The nomination process should be transparent and criteria for the skills and knowledge required collectively by the governing boards should be established. Furthermore, the requirement for Swedish citizenship of members of the governing boards could be lifted.

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