Regeringskansliet

Memorandum

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Pilot study of possible structural changes for a more secure and more efficient premium pension system

This pilot study will be supplemented with appendices related to the research projects in Chapter 2.6. These will then be reported in connection with the pilot study on the government website.

Foreword

When the Pensions Group asked me to conduct this pilot study, my immediate reaction was that it was an assignment I could not turn down. As an expat Swede and pensions expert working in the Netherlands and the UK, it is incredibly exciting to have the chance to contribute to the future of the Swedish premium pension system. A positive side effect of the task was that it made me feel young again, as it had been quite some time since I had a summer job. Given the very short time frame of 10 weeks, which also coincided with the Swedish summer holiday period, I am eternally grateful for all the generous help I received from a number of individuals and organisations. It is clear that improving the premium pension is an issue that generates a great deal of interest.

My meetings with those who have led previous premium pension inquiries, Stefan Engström and Patric Thomson, were very informative and there is clear consensus on what the fundamental problems are. Mats Langensjö, who led an inquiry into the buffer funds, made a valuable contribution based on his experience from leading that inquiry.

Despite the very short time frame, four international research teams contributed valuable knowledge to the pilot study, on issues such as the behaviour of individuals within the premium pension system. Ole Settergren and his colleagues at the Swedish Pensions Agency's analysis department deserve particular recognition. Despite the holiday period, they were extremely helpful in giving access to data for these research projects.

I would like to direct a word of thanks to the international experts who contributed insights, in particular Manuel García Huitrón (IDB), Ian Beckett (The Treasury, Australia), Paul Todd (NEST) and Alan Pickering (BESTrustees). Emma de Haan (Cardano), who reviewed and compiled the historical development of occupational pensions in Australia and Chile, did a fantastic job.

I had the opportunity to talk to many people involved in the Swedish pensions market – labour market partners, occupational pension selection centres, trade associations, authorities and a number of other pension-related organisations – and this was very informative.

A working group at the Government Offices of Sweden (Ministry of Health and Social Affairs and the Ministry of Finance) has been invaluable in constructively challenging my arguments and making my texts readable. All opinions, remaining errors and mistakes are, of course, my own.

The Pensions Group was clear that this should not just be yet another inquiry but that it was time for action. This pilot study therefore provides a practical overview and compilation of known information and knowledge. My contribution has been to apply this to a context that is relevant to the premium pension system. I hope that the Pensions Group can use this roadmap to establish what the main emphasis should be placed on to enable the premium pension system to move towards the future, with a clear focus on a secure system based on how individuals act when faced with choices in real life.

Stefan Lundbergh

Summary

The premium pension system – a product of the 1990s

The premium pension system is a product of its time and reflects the knowledge and environment that prevailed in the 1990s. Public interest in fund-based saving in Sweden was gradually increasing in the 1990s and by the end of that decade, the stock market had rallied. It was natural to want to benefit from the excess capital market returns and, since many people were already saving in mutual funds, fund-based savings seemed the obvious choice. There was also a belief that more people would take an interest in their savings and actively switch funds. The design was innovative and no practical experience of similar systems was available. In addition, there was limited knowledge and experience of how people actually behave when confronted with choices. The design of the premium pension system is consequently based on the beliefs of how people would act and not on how people actually behave. The assumption was that a financially rational saver with access to transparent information will actively choose the mutual funds that best correspond to their needs.

Uninterested savers lead to a poorly functioning market and an ineffective system.

The design that was adopted assumed that active and informed savers would select good mutual funds and rejecting bad ones. This would squeeze out unprofessional providers and underperforming funds. The reality turned out to be a different story and it has become clear that more information does not help – you cannot inform people who are not interested. We now know that there is significant insecurity and lack of interest among savers. This has led to the emergence of a market for advisors to help savers choose. The result of this has been a number of unprofessional operators establishing themselves and using relatively aggressive approaches to exploit savers' lack of interest and insecurity. This has damaged confidence in the premium pension system and the pension system overall.

The design of the premium pension system is based on that financially rational savers gathering information on individual mutual funds and make active choices on the open fund platform. The field behavioural economics and the empirical research of how people make choices regarding their pension savings was limited in the 1990s, but has developed considerably since then. The research clearly shows that people are not engaged when it comes to financial choices about pensions and consequently do not make

choices, allow themselves to be guided or making rather extreme choices. These results and experiences from other countries with pension solutions involving elements of choice are remarkably similar to those in Sweden. It is clear that we need a system that is based, to a greater extent, on how people actually behave and a system that protects consumers.

The premium pension system is part of the social security system and its design should be more reflective of this.

The income pension and the premium pension are pension insurance schemes and essentially have the same purpose – to help provide a basic protection of the living standard in retirement. Despite this, the two components of the state pension are noticeably different. Most people regard the income pension as a form of insurance. The premium pension is also a form of insurance but fully funded; however, it is usually viewed as a form of personal financial savings. The state pension constitutes the basis for the financial security of the elderly, particularly for those with low incomes. The premium pension should therefore be viewed to a greater extent as the social security it actually is. The state, which mandated the compulsory pension saving, consequently also needs to take greater responsibility for this element of the social security system – for the design of the system and for secure and reasonable outcomes.

The premium pension system lacks an explicit goal

The premium pension system has a number of purposes and aims, but the state has never established an explicit goal for what the premium pension should achieve. For example, should income security or maximised returns be the priority? In the absence of a goal, it is unclear what product and what results should be aspired. Consequently, the goal and investment policy are in practice established at the level of authorities, or by individuals choosing mutual funds. It is reasonable that strategic decisions should be taken at the political level, as the premium pension is part of the state pension.

The goal of the premium pension should be considered carefully and thus no final goal has been established as part of this pilot study. To prepare the roadmap covering the possible alternatives, the following goal-related criteria have been formulated:

1. The premium pension is a compulsory social security system for which the state has overall responsibility.

2. Investments should prioritise insurance before savings and target a stable lifelong pension income.
3. Over time, returns should exceed the income index.
4. For those who are interested, there should be the opportunity to choose from quality-assured alternatives.
5. Risk in the premium pension should not be higher than in an occupational pension.

One main track with possible ancillary alternatives

This pilot study recommends a main track but also proposes different alternatives that could be implemented. The choice of the main track is justified by it being an adequate way of meeting the goal-related criteria while also taking account of the fact that we are inheriting a pre-existing fund platform.

The foundation of the main track is a default choice based on an insurance inspired solution that aims to achieve a secure pension income without requiring individuals to have the relevant knowledge and interest. People should feel secure in knowing that their premium pension is being managed well throughout their lives without requiring their active involvement. For those who wish to exercise some influence on their premium pension, but do not want to be actively involved, it should be possible to choose between a few solution packages that are put together with the goal-related criteria in mind. For those who choose one these solution packages there should typically be no requirement for actively monitor performance or to make new choices.

The default choice and these solution packages form the basis of the main track, for which the state bears particular responsibility for the outcome – not as a guarantor for a certain level of return, but to ensure there is a good balance between a stable and reasonable pension income and financial risk taking. The default choice should, in practice, have features that are inspired by traditional pension insurance. The solution packages could be variants of the default choice but offering another degree of stability, or variants of so called ‘generation funds’.

For those who wish to leave the secure choice environment with default choice and solution packages, the main track contains a possibility for the individual to take on full responsibility for investing their pension money and compose their own portfolio on a fund platform. It must be made clear to those taking this step that they are also assuming responsibility for their outcomes. The fund platform has one vital difference from the current open fund platform. The new platform would be based on professional procurement of mutual funds. There is an appointed principal that manages the fund platform and has responsibility for ensuring that the platform continually offers a choice of quality-assured and cost-effective mutual funds. The principal consequently have the authority to determine, on a professional basis, which mutual funds to include or not. An important aspect of the principal's task is to monitor the quality of the mutual funds and thereby minimise the risk of unprofessional operators. To manage this, the number of mutual funds on the fund platform will gradually need to decrease from the current level. The number of mutual funds will be determined by the principal on a professional basis and will depend on demand, the benefit for the individuals and the ability to maintain a cost-effective and secure fund platform. This way, the state will also take responsibility for those individuals who want to make their own choices – not for the outcome, but to ensure that quality, effectiveness and focus of the mutual funds on the platform are reasonable. It is a model that resembles the way most fund platforms on the market are currently managed by their owners.

1. Introduction

Since its introduction, the premium pension system has been subject to debate, and there have already been three public inquiries tasked with reviewing and propose improvements to the system. In 2016 and 2017 the premium pension system came under particular scrutiny after abuse of the fund platform which led to people losing pension rights and receiving lower pensions. Such abuse, and in certain cases downright criminal behaviour, appears particularly striking, as the premium pension system is part of the state pension and social security systems. In other words, it is a form of compulsory saving established by the Parliament (Riksdag).

It is in light of this situation that the six parties, comprising the cross parliamentary Pensions Group, that manage the Swedish pension system have decided to conduct a pilot study of possible structural changes to the premium pension system in order to achieve more secure pensions and a more effective system. The remit of the pilot study includes analysing different alternative approaches to how the premium pension system could be improved to achieve a better system that is more secure in the long term. The pilot study’s remit is detailed in Appendix 1.

The premium pension has fulfilled two of its main purposes: a higher return than the income pension and diversification. However, a lot has happened since the guidelines for the design of the premium pension were established over 20 years ago, and there is consequently good reason to review whether the current design is optimal for its purpose.

Every system is a product of its time and is based on the knowledge and conditions that existed at the time it was developed. Conditions change and there have been significant advances in cognitive psychology that today give us a better understanding of the drivers involved in how individuals act in terms of applying their freedom of choice to financial products. In addition, there is extensive domestic and international experience of different policy measures that have been implemented in order to engage individuals in using their freedom of choice and thus encourage the market forces to work better through competition on price and quality.

A pilot study, of course, adopts an overarching approach and this report therefore does not contain any detailed proposals. Its aim is to present a number of central junctions that could provide the basis for outlining a future direction.

The report has been structured as follows. It begins with an introductory review of the experience gained since the premium pension was designed (Chapter 2). It then discusses the purpose of the premium pension and what objective should govern its design (Chapter 3). Finally, overarching proposals are made for the design of a partially amended system and for alternatives to this (Chapter 4).

1.1 The premium pension is part of the pension pyramid.

The Swedish pension system is often illustrated as a pyramid consisting of different layers that together form an individual's overall pension income.

Since the pension reform, it has been politically stated that the labour market partners and occupational pensions has a role for the individuals overall pension. The level of contribution for the state pension was set on the basis that occupational pensions do and should exist. For most people who work, pension premiums are paid corresponding to 21.71 percent of salary, for their sate pension (17.21) and their occupational pension (4.5).

The Swedish pension pyramid helps individuals to plan their consumption over the course of their life cycle and to minimise the risk of an excessive reduction in their standard of living when they retire. The tax on pension contributions are deferred until pensions is paid out. This tax incentive makes it more attractive for individuals to save and it distribute the tax revenues over the entire life cycle of the individual.

Different levels of the pension pyramid correspond to different needs and therefore have different levels of paternalism (enforcement). Meeting the needs in the different levels of the pension pyramid requires different types of solution. The base of the pyramid focuses on social security and consequently involves a high degree of paternalism. The higher up the pyramid we move, the more freedom of choice and individual responsibility is given to individuals and a higher degree of risk-taking is permitted. For private savings, without any tax deferral, individuals have complete freedom of choice, but the individuals are then entirely responsible for the consequences of their choices. It is worth noting that, the premium pension, which is part of the base of the pension pyramid, allows both high levels of risk-taking and significant individual freedom of choice.

The base on which the pension pyramid rest, is the **guarantee pension** that is paid to everyone who did not have a sufficiently high income during their career in order for the self-funded state pension to provide basic financial protection. This social safety net is tax financed. The **income-based state pension** covers everyone who has received a salary. In total, an employer and an individual pay in pension contributions of 18.5 percent of pensionable income to the state pension[1]. 16 percent goes to the income pension, which is a pay-as-you-go system with a capital buffer and 2.5 percent goes to the premium pension, which is a fully funded system. The state pension aims to provide a lifelong and relatively stable income, but the size of the income is not guaranteed; instead, it will develop depending on how the real economy and financial markets develop. There is an upper limit, a ceiling, on the contributions to the income-based state pension system. For the portion of pensionable income that exceeds 7.5 income base amounts, 10.21 percent is still paid in pension contributions, but no additional pension entitlement is granted for this. This is essentially a tax on high incomes. In contrast with the tax-funded guarantee pension, the state pension is funded outside the national budget. This means it is the individual, and not the state, that bears the financial risk.

Occupational pensions are part of the collective agreements between labour market partners. The occupational pension gives individuals additional pension contributions, which correspond to 4.5 percent of salary.

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[1] An individual's pension contribution is not in itself pensionable income, which means the pension contribution is 17.21 percent in relation to salary.

Legislation stipulates that upon retirement an individual can draw their occupational pension over the course of their life or over a given period, which must be a minimum of 5 years. For the part of income that exceeds 7.5 income base amounts, there is no income-based state pension, and in this regard collective agreements instead provide individuals with 30 percent in pension contributions. The design of the occupational pension is determined by the labour market partners. For high income earners, it is often favourable, in tax terms, to use salary reduction plan, i.e. to swap part of their salary for pension contributions, which is essentially a form of individual pension saving under the occupational pension. A challenge for the welfare system is the growing proportion of self-employed people, who are not covered by collective agreements.

The top of the pyramid consists of **private pension saving**. Since 2016 there are no additional tax-deferral of pension savings for those with an occupational pension. Self-employed people may still use private pension savings to build up their pension, but these are optional pension savings.

1.2 The Swedish pensions model aims to provide a standard level of protection

In the Swedish model, the state pension is part of the social security system and is designed as a standard level of protection – the state pension aims to ensure a standard of income and higher income level leads to a higher state pension. The state pension, however, is at a lower level than salary. Occupational pensions are not statutory in Sweden and therefore essentially comprise voluntary pension savings. The labour market partners, however, have chosen to make them compulsory for everyone covered by their collective agreements. To protect individuals with lower pension incomes, in addition to the guarantee pension, there is a social safety net outside the pension agreement in the form of a housing allowance and maintenance support for the elderly. In Sweden, we perceive it as reasonable for a person to be able to stay in their home when they retire, and this avoids that a low state pension automatically leading to poverty.

In the Anglo-Saxon model, the state only offers protection against *absolute poverty*, which means that the state pension is close to the poverty levels. It is up to the individual to save – via occupational and private pensions – to ensure a satisfactory lifestyle as a pensioner. If an individual chooses not to save for a pension, it is considered fair that the person has to live at the poverty level as a pensioner. It is an individual's own decision and the individual, not taxpayers, must therefore accept the consequences. The Anglo-Saxon view is that if the individual cannot afford to remain in their house when they retire, it is fair that the individual has to move to cheaper accommodation, often of a lower standard. The task of the state here, beyond protecting against absolute poverty, is limited to ensuring that the pension savings market functions by introducing regulations that protect individuals and create competition.

The Swedish model takes a different view of responsibility. For voluntary savings, the responsibility for how such savings are made naturally lies with the person who decides to set aside money for such saving. However, the Swedish state pension system is a compulsory part of the social security system, which exists to guarantee reasonable provision throughout old age. Here, the amount of savings for one's own pension is determined not by the individual but by the state, and the state should therefore have at least overarching responsibility for how this money is invested so that the savings do not, as a result of imprudence, develop unfavourably for the individual or become misused by unprofessional financial service providers. Poor development of savings for the individual can also to some extent have a knock-on effect for taxpayers via the social safety net outside the pension agreement, which is also why it is reasonable for the state to bear overall responsibility for the level of risk, which affects the outcome.

2. The premium pension journey – what have we learnt?

It is important for the future design of the premium pension system that we learn from both the strengths and weaknesses of the existing system. It is important to open-mindedly analyse how people act when faced with the choices in their premium pension. It is particularly important to analyse the differences between how individuals act and how economic theory/ideology assume that individuals will act. These observations provide us with valuable information about how we can improve the current solutions.

Standard practice in the aviation industry is to carefully and objectively examine what caused accidents/incidents. That is why every commercial airplane has two black boxes, one recording the conversations of the pilots and one collecting technical data, so the investigators can reconstruct what happened. The results of such investigations are shared publicly so the entire industry can collectively learn from each other's mistakes. There is similar international transparency for defined-contribution pensions. Three public inquiries into the Swedish premium pension system have already been conducted. Since the mid-1990s many countries have 'experimented' by introducing different forms of freedom of choice, mainly within occupational pensions. Some of these countries have implemented a number of reforms to manage the 'unforeseen' subsequent problems, so we are able to study how effective such measures have been.

All the choices made by individuals under the premium pension system are registered and stored at the Swedish Pensions Agency. One might say this is equivalent to the black box that gathers the data in an airplane. For obvious reasons, however, there is no black box containing information about what an individual was thinking when he/she arrived at their decision. Since the premium pension system was created, however, in-depth international research into how human behaves when faced with choices has emerged. This can be used to understand how individuals make decisions.

2.1 Development of the premium pension system since its inception

The overall guidelines for the premium pension system were decided by the Parliament (Riksdag) in 1994, and the details of the system's design was decided in 1998. Actual contributions for the premium pension began as early as 1995, but were collected in deposit awaiting the launch of the fund platform.

Parallel to this, there were significant changes to the pension and savings market in Sweden. Unit-linked insurance was introduced in 1990 and in the following year, the Swedish financial market rules were adapted to EU directive about fund management companies, the EU UCITS Directive.

Since inception of the premium pension, changes in terms of approach and directives have been made, but essentially within the original design. Three public inquiries have been undertaken to evaluate and improve the system. The following describes the journey that the premium pension has been on since inception.

2000–2005

In 2000, for the first time, savers were able to invest their premium pension contributions in the fund platform, which back then consisted of 450 funds. The fund platform was open to all mutual funds that met the UCITS requirements.

For those who did not select a portfolio of mutual funds, there was a default choice provide by the state: the Premium Savings Fund. This was managed by the Seventh AP Fund (AP7) and it was not part of the fund platform in the sense that once you had chosen a set of mutual funds on the fund platform, you could not choose to go back to the Premium Savings Fund. The goal for the default choice was to, at least match, the capital-weighted average of other funds on the fund marketplace, but at lower risk.

There was a huge marketing initiative prior to launching the platform for individual choice. One of the main aims of the Swedish Premium Pension Agency's communication efforts was "to get as many people as possible making an active choice". All savers were provided with a selection package containing a catalogue with information about the different mutual funds and instructions, outlining a number of steps, how to choose.

Private companies launched advertising campaigns and other forms of customer communication to encourage as many savers as possible to choose their funds, e.g. from Handelsbanken's brochure *Ditt fondval hösten 2000 [Your fund choice, autumn 2000]*: 'The pension system now offers a new feature that gives you significant opportunities to influence your pension – you can choose funds yourself. Take the opportunity – invest your premium pension in Handelsbanken's funds!" AMF's mailshot contained wording such as "a golden opportunity", "the premium pension should grow to provide a considerable increase in pension", "Time to get the selection form out and choose your funds!"

The general impression at the time of the introduction of the premium pension was that it was important to choose and that people should make an active selection in order to get a good pension. In a roundabout way, it might be said that an active choice was emphasised as a kind of default, while not making a choice was only a last resort if you simply could not decide what to choose. The result was that 67 percent of 4.4 million pension savers selected mutual funds on the fund platform at the time of the introduction. Of these, almost 40 percent, or 1.1 million savers, have not made any new choices since then.

Over the years that immediately followed the introduction, the Swedish Premium Pension Agency's information objectives were changed from *Aktiva val [Active Choices]* in 2000 to *Medvetna val [Informed Choices]* in 2001 and *Främja kunskap [Encouraging Knowledge]* from 2002.

2005–2010

In June 2004, an inquiry was established to evaluate the premium pension system, focusing on reducing the risk of systematically bad outcomes and making it easier for individuals to choose. The inquiry submitted its findings in the 2005 report *Svårnavigerat? Premiepensionssparande på rätt kurs [Difficult to Navigate? Premium Pension Savings on the Right Track] (Swedish Government Report 2005:87).*

> The starting point of the inquiry's work was not to create a new system but to propose improvements within the existing system. The inquiry was tasked with identifying possible problems relating to actual and expected difficulties in supporting individuals' choices and switching funds by providing information and guidance. The inquiry was also tasked with assessing to what extent enhanced information and guidance could improve the results and reduce the risk of systematically bad outcomes.
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> The inquiry concluded that the premium pension system should continue to be a unit-linked insurance system with asset management taking place in mutual funds administered by independent fund managers, which could also be state-owned. State-owned fund managers should operate on the same terms and in full competition with the private fund managers.

The inquiry argued that those fund managers that meet the requirements could in principle openly register their funds for the system. The Premium Pension Agency would not assess whether, or not, a mutual fund was suitable for inclusion in the system.

The inquiry's view was that pension savers' needs should guide the operating activities of the Premium Pension Agency. A guideline should be that pension savers have significant opportunities to handle the management of their mutual fund portfolio to ensure they received a good premium pension.

The inquiry divided pension savers into three groups requiring different asset management solutions:

1. Those who consider they have neither the knowledge or the interest to design and administer their own portfolio of mutual funds. Their capital should be managed under the system's default choice.
2. Those who consider they have an interest but not sufficient knowledge. They need well-designed decision support system.
3. Those who believe they have both sufficient knowledge and interest. They can select and switch funds on the fund platform with, or without, a decision support system.

Based on this classification, the fund platform should have, as its primary target group, those pension savers who consider themselves as knowledgeable and interested. The inquiry's view was that insufficient consideration had been taken of target group 2's need for a decision support system. Choices for this group should be made easier by offering detailed documentation to support decisions on managing premium pension money. Such documentation would also reduce the risk of systematically bad outcomes. All pension savers would be offered such decision support system. A reasonable arrangement would allow pension savers, who do not wish to receive all or parts of the guidance, to actively cancel the process.

In addition, the inquiry found that the default choice of the premium pension system should have a generation fund type of structure, which reduces the level of risk as the pension saver ages. The entire combined state pension, including income and guarantee pension, should be taken into account when establishing the risk level of the default choice. The requirement for low risk in the management of the Premium Savings Fund should be replaced with the prudent person principle.

The Swedish Premium Pension Agency should be given tools that would help them to reduce the number of mutual funds offered to around 100–200 funds. This should not be an absolute target but should rather be a range based on the extent to which pension savers chose to use the range of funds. The more detailed considerations balancing costs and freedom of choice would be transferred to the Premium Pension Agency. The reduction in the number of mutual funds was not necessarily due to the large number of funds, but rather by the lack of detailed documentation and a decision support system. Without this there was a risk that savers were not diversifying their mutual fund portfolios or were making other mistakes in their investment management.

During the years 2005–2006, the Premium Pension Agency developed the IT-based decision support tool *PPM-Lotsen [PPM Pilot],* the aim of which was to help pension savers make informed and well balanced choices. However, this decision support tool was not extensively used by pension savers.

In 2006 and 2007, the Premium Pension Agency sent out a mailshot to those pension savers who had chosen mutual funds when they first joined the premium pension system but who had not changed their mutual fund holdings since then. When measuring the impact of these campaigns, around 10 percent said that they planned to seek information about switching mutual funds. In 2008, a similar targeted mailshot was sent to those who had their premium pension money in the Premium Savings Fund and had therefore not made an active selection of mutual funds. The mailshot included a brochure entitled "What do you want to do?" Follow-up of this also demonstrated a low level of interest.

In 2009, changes were decided on, mainly regarding the design of the default choice. The new default choice AP7 Såfa was a generation fund arrangement that could also be actively selected on the fund platform. There was still some hope that those who did not want to select mutual funds on the marketplace would at least want to choose the level of risk. The fund platform is therefore supplemented with three portfolios with different levels of risk, managed by AP7. The aim of the changes was to adapt the system to savers' knowledge and interest. The purpose of the default choice was changed from generating a return of at least the average on the fund marketplace, but with lower risk, to also taking account of the income pension system in the risk assessment. However, the risk level was not specified in law and in practice, the risk level had to be determined by AP7. Based on this, AP7 chose relatively high risk, with equities exposure through leverage at over 100 percent which resulted in that the default choice had a higher equity exposure than other funds on the fund platform.

2011–2015

As many individuals could not, or did not, want to choose mutual funds themselves, an advisory market emerged. The first advisors, the 'premium pension advisors', started offering their services as early as 2005. The advisory market then grew significantly, and in 2011 the Swedish Pensions Agency stopped large-scale fund switching based on power of attorney from the individuals. After this intervention, the large premium pension advisors transferred their clients to their own mutual funds, which were specially created for the premium pension system. These funds were then often marketed aggressively through telemarketing. Since everyone who works, or has worked, in Sweden has money in the premium pension system, the list of potential customers is basically the same as the phone book. Despite large-scale fund switching being stopped, in 2015 around 600,000 pension savers, over one in six of pension savers with their own portfolio, used premium pension advisors for the management of their premium pension.

During this period, 'generation funds' also begun growing in popularity. The idea behind a generation fund is that the composition of the portfolio changes automatically as an individual grows older. An individual chooses a 'provider' offering a fund-of-funds – a form of automated advisory service.

In March 2012, the Pensions Group launched an evaluation of the premium pension system. The inquiry was presented in May 2013 in the report *Vägval för premiepensionen* [*Premium Pension Choices*] (Ds 2013:35)

> The aim of the inquiry was principally to clarify and analyse the function of the system and, secondarily, to identify possible methods for managing the issues that were identified. The aim was to provide a basis – different alternatives – for the question "What premium pension system do we actually want?"

The memorandum noted that the design of the current system leads to three problems that need to be addressed:

1. A relatively large expected distribution of outcomes.
2. A large range of funds is difficult for most savers to cope with.
3. Higher than necessary costs.

These problems are largely the result of individuals being less financial literate than was assumed and the wide range of mutual funds. Managing these problems therefore involves limiting the freedom of choice that currently exists – in other words, putting a price on what an extensive freedom of choice is worth. It's a question of values – which features to prioritise and which effects are preferred. The memorandum points to two alternative paths which, to different extents, address these problems and amend the design.

The first alternative is based on the current fund platform with an essentially unchanged number of mutual funds. To mitigate the problems identified, a confirmation choice is being introduced and the default choice is being more clearly emphasised as a good alternative for those who clearly do not want or are unable to choose for themselves. Restrictions on costs and risk are being introduced, which will probably lead to some reduction in the number of mutual funds and a reduction in the risk of bad outcomes as a result of limited financial literacy.

The other alternative involves the creation of a new fund platform, with up to 10 selectable funds managed both internally and externally. The funds should have different risk and investment focuses, which can be chosen freely. This also includes a default choice corresponding to what is currently available. To the extent that the distribution of returns between individuals is regarded as too problematic, the limited fund platform could be reduced to one collective fund, which would lead to lower costs.

Which approach to take is thus a question of values. The first alternative prioritises freedom of choice at the expense of costs and distribution of outcomes. The second alternative better addresses the three problems but at the expense of the freedom of choice being restricted.

In July 2014, the government appointed a new premium pension inquiry in order to move forward with some of the proposals in the Premium Pension Choices memorandum. In September 2016, the inquiry presented its findings in _Fokus premiepension_ *[Focus on the Premium Pension]* (Swedish Government Report 2016:61)

> The basis of the inquiry was the proposals for measures according to alternative 1 of the Premium Pension Choices memorandum, i.e. measures as part of the existing system with significant freedom of choice. The purpose of the inquiry was to ensure that any changes to the premium pension system helped ensure more savers getting good long-term returns on their premium pension capital at a reasonable risk and cost, which the inquiry interpreted as the proposals provided by the inquiry increasing the likelihood of more pension savers achieving better premium pension outcomes.
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> The inquiry's assessment was that more pension savers and pensioners could achieve a better premium pension outcome without the need to reduce opportunities to choose from a wide range of asset managers and mutual funds with different focuses (freedom of choice) for those who wish to make use of such opportunity. This could be achieved by reforming the system with regard to selection procedures and information from authorities.
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> The proposals could be said to relate to implementing a shift in focus from choosing funds on the fund marketplace (Own Portfolio management model) to offering three management models (Own Portfolio, Standardised Risk Portfolios and the Default Choice). The inquiry's assessment was that measures in the form of amended selection procedures and clearer information from authorities with a focus on the basic choice of management model are the most effective way, as part of the existing system, to increase the likelihood of more people achieving a higher return in the long term at a reasonable risk and cost. These measures are also assessed to reduce the distribution of outcomes, although such distribution will still exist as a result of the selection opportunities that exist.
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> The inquiry's proposals are based on the assessment that there is reason to assume that a low level of interest and knowledge reduces the likelihood of achieving a good premium pension outcome and that the solution to this fundamental problem lies not in trying to increase the level of interest and knowledge but rather principally in adapting the system to pension savers' level of interest and knowledge.

The inquiry proposes that regular confirmation choice be introduced for those who have chosen the Own Portfolio or Standardised Risk Portfolios. These will provide savers with information about the fact that the purpose of the confirmation choice is to reduce the risk of a low premium pension outcome and to choose whether they want to retain their current mutual funds, switch mutual funds or select a different management model. Those who do not register their selection within the prescribed period will have all of their premium pension capital transferred to the Default Choice.

The inquiry's assessment is that the current arrangement whereby new money is invested in the same way as previously and investment of the old money is not regularly reviewed cannot be regarded as being most consistent with the level of interest of the average pension saver.

Among the disadvantages of such a proposal, the inquiry mentions that some pension savers will be required to made a greater number of active choices than currently and that there is a risk that an arrangement involving regular choices could create 'choice fatigue' and pressure on savers with Own Portfolio or Standardised Risk Portfolios to take an active interest in managing their premium pensions, which does not suit everyone and would not be appreciated by everyone.

The inquiry's assessment is that no restrictions should be introduced for the offering on the fund platform with regard to risk, based in part on the difficulties that exist in terms of establishing the limits between permitted and unauthorised risk and the expected effects of excluding those funds with the highest risk.

In 2015, the Swedish Pensions Agency officially changed its communication so that it emphasised the default choice.

2016–2017

In recent years, some fund management companies with dubious business methods have appeared on the fund platforms. The highest-profile of these is the Maltese fund management company Falcon Funds, which raised money using unethical and sometimes illegal methods, including by hacking savers' e-identification and packaging money in non-transparent securities, which allowed the money to be used as private venture capital. SEK 1.2 billion of pension savers' money is still missing. Those approximately 22,000 savers affected are people who typically have not previously switched funds. Following the detection of Falcon Funds' methods, a continued review of the fund platform has led to four other fund management companies being stopped and their mutual funds have been de-registered, with similar suspicions of criminal activity. A number of providers have also been reported to the police. In conjunction with this, it has become clear that a large part of the capital on the fund platform is held outside the reach of the Swedish Financial Supervisory Authority, the regulatory authority.

As a result, of the suspected criminal elements on the premium pension fund platform, in December 2016 the government tasked the Pensions Agency, within the current regulatory framework, with analysing and proposing measures that strengthen consumer protection and reduce the risk of fund management companies abusing the system. A report with proposed measures, known as the 30-point programme, was submitted by the Pensions Agency in June 2017. One of the fundamental proposals is to introduce a number of criteria that the fund management companies and the mutual funds on the fund platform must meet in order to weed out unprofessional operators. As a second stage in creating a more secure fund platform, this pilot study is being undertaken to analyse alternative possibilities for more structural changes to the premium pension system's fund platform.

2.2 Summary of the inquiries and developments

The evolvement of the premium pension over the past 20 years and the previous three inquiries present an interesting picture of the journey the premium pension has been on. After the choices made at inception, it quickly became clear that savers were not choosing and switching funds to the extent assumed when the system was designed. It was concluded, at that time, that this could be explained by that savers were *unable* rather than *unwilling*. The solution was to introduce a decision support system which consisted of supporting documentation and guidance. It was assumed that it would result in more people to take an interest, and then competition would lead to self-regulation of the mutual fund offering on the platform.

The decision support system that was provided did not generate the desired effect and the level of activity in the system remained at relatively low levels. Targeted information mailshots were tried to inform people of both the opportunity to choose and that help that could be obtained when making a choose. This action also failed to increase the level of activity.

Meanwhile, products were emerging that relieved savers of the need to make a choice. In generation funds, the fund management company determined when the portfolio allocation needed to move from riskier investments when an individual was younger to more secure assets as they approached retirement. For a fee, premium pension advisors offered to take over the management of savers’ accounts and make the investments that they assessed to be correct. A combination of relief of not having to choose and aggressive, and sometimes misleading, marketing by fund management companies and advisors resulted in more and more people transferring their freedom of choice to providers and advisors. This situation threatened to undermine both IT systems and public’s trust in the system. Stopping premium pension advisors’ large-scale fund switching led to that these companies created their own mutual funds solely for the premium pension system. The original idea that the premium pension fund platform would reflect the market’s offering of investment strategies and fund management companies was slowly eroded.

The communication gradually changed from having to choose a mutual fund and it being important to take an active approach, to the default choice being a good alternative for most individuals. If more individuals go for the default choice, this reduces the risk of a significant dispersion of outcomes, but not the risk of bad outcomes. The default choice since 2010, AP7 Såfa, has a high risk level, up to the age of 55 the individual has currently an exposure of 125 percent to the equities market through the use of what is known as leverage. This generates especially good returns when the equities market rally and especially bad returns when the equities market plummet, compared with an equities fund without leverage.

The inquiries of recent years note that the financial literacy of savers is lower than was predicted, but in particular that the willingness to choose is much lower than was assumed when the system was created. The wide range of mutual funds results in that savers are overwhelmed by the sheer number of choices and consequently often refrain from using their freedom of choice or choose to transfer the responsibility to an advisor. The solution has been to further highlight the default choice and to ‘nudge’ those savers who have ended up on the fund platform, but did not really want to be there, back to the default choice. The current discussion is about adapting the system to pension savers' interest and knowledge rather than trying to adapt individuals.

The idea of an open fund platform was that savers would act as informed buyers and consequently that would result in that the supply of mutual funds would self-regulate through competition. Since there is no principal with a clear overall responsibility for the fund platform, problems arise. As a result of these corporate governance problems, less scrupulous fund management companies have exploited the situation. The lack of a principal results in insufficient supervision of the fund marketplace. Half of the funds on the marketplace are not under Swedish supervision. In its consultation comments on the latest inquiry, the Swedish Financial Supervisory Authority states that it is not possible for them to supervise the current mutual funds on the platform and recommends a fund platform with a small number of Swedish-registered funds.

2.3 International experience is in line with the Swedish experience

In other countries, the state pension system is more of a general entitlement, with no option for individuals to make their own choices. Some countries have funded elements in their state pension. In Denmark, for example, the pension savings are collectively management without possibilities for individuals to influence how it is managed. Many countries, however, have funded occupational pension systems that provide varying degrees of freedom of choice in terms of how the money is invested. The debate and developments in these countries are similar to those in Sweden with regard to the balance between the extent of freedom of choice and the extent of regulation of choices and the role of default choices. The debate has moved from a strong belief in individual capability and interest in making active choices to an insight into how individuals actually act and adapting the system based on this. Other countries, have to a greater extent than Sweden, introduced certain changes to their system. In terms of the premium pension, Australia and Chile could be of particular interest, as they have a long tradition of defined-contribution solutions with individual freedom of choice within occupational pensions. Although there are significant differences in culture and how the pension pyramid is structured, it is relevant to study how individuals manage their freedom of choice, and how the measures introduced to increase competition and protect individuals have worked in practice.

The UK's occupational pension reform of 2008 is also interesting to study, as it was implemented recently and was based on experience from academic research in behavioural economics and experience from other countries.

Australia

In Australia, there is a strong belief that market mechanisms work assuming that individuals are involved and interested. The role of the state is typically restricted to ensuring that the market is working optimally through regulation.

In the 1980s, a funded occupational pension system was introduced. Voluntary pension savings were encouraged from the start through tax incentives. Despite this, there was only marginal uptake, so occupational pensions became mandatory.

With a growing occupational pension market, a number of problems emerged when some of the occupational pension providers added expensive and complicated components to their occupational pension products. To resolve this problem, a regulatory authority was established and greater transparency was made compulsory with regard to fees and investment returns. It was assumed that individuals and employers would put pressure on occupational pension providers to offer better terms and conditions. When this did have the intended results, individuals were instead allowed to switch occupational pension providers with the hope that individuals would opt out from bad solutions, but only a small percentage made use of the transfer rights. The low level of activity was partly explained by behavioural factors and the fact that it was difficult to obtain the relevant information. An advisory industry emerged, which led to new problems.

From 2010, the government became increasingly sceptical about the market's ability to solve these problems, which led to more detailed regulation and, to a larger extent, based on how consumers actually make choices. A central measure was to require all occupational pension default choices to be a standardised product, with clear transparency regarding costs, fees and returns. The conclusion was also drawn that individuals were not willing to engage and that further transparency and information would not result in a better functioning market. Many of those who actually made a choice did so on the recommendation of an advisor. These advisors received commission from the providers of the products they are selling, which created other problems. This subsequently led to commission being banned.

There is currently an ongoing policy discussion about the possibility of considering the occupational pensions as an institutional market instead of a consumer market. This could mean that the standardised product would be procured via tender or auction – a significant step in an otherwise Anglo-Saxon market environment.

Chile

Chile was one of the first countries to reform its occupational pension system from a defined-benefit to defined-contribution system. The financial crisis in 1982 forced a reform and the new system became mandatory. Special commercial pension funds were created, known as AFPs (Administradoras de Fondos de Pensiones). They could only offer one product and there was clear detailed regulation of that product. The assumption was that, as a consequence of one standardised product, competition between AFPs would lead to lower costs and better quality for savers.

Over the next 20 years, it transpired that the competition between AFPs did not arise through competition on price but rather by offering savers gifts (such as toasters, sneakers and bicycles) if they chose to transfer their money. Fees and costs for savers were high: in 1994, they amounted to 10 percent of annual contribution payments.

Critics said the costs of freedom of choice – between providers of what was in practice a standardised product – had become too high due to a lack of competition. It was considered that if the AFPs were allowed to offer more than one product, competition would increase, thus reducing the costs of the system. In 2002 the system was reformed, allowing AFPs to offer five generation fund arrangements that individuals could choose between.

The increase in options did not solve the basic problem of high fees. To improve competition, an auction mechanism was introduced in 2008, where the AFPs had to submit bids. The winner of the auction received all premiums from new savers over a two-year period, but the fee level from the auction also had to be offered to existing customers. After 18 months with the winning AFP, individuals were entitled to move their savings and the AFP could then raise its fees.

The auction mechanism resulted in lower prices, but 80 percent of savers continued to stay with their original AFP, paying a higher price than necessary. Only one AFP participated in the most recent auction in 2016. To solve this problem, a state-owned AFP was recently proposed.

It is important to note that despite a standardised product offering and a significant difference in price, many people opted not to engage with the system. There was a lack of price competition and the market powers failed to provide individuals with an attractive price for a standardised product.

United Kingdom

The UK introduced an occupational pension reform in 2008 known as auto-enrolment, which meant that all employers had to offer employees an occupational pension from which the employee could decide to opt-out. The funding of the system is very favourably structured, making it rational for employees to stay in the occupational pension. The default choice for individuals is to participate in an occupational pension scheme, i.e. individuals must actively decide to opt-out. This has led to a very high proportion of employees participating in an occupational pension scheme.

From a design perspective, the UK had the benefit from its late, compared with other countries, introduction of a mandatory occupational pension system and was able to create a solution based on both experience from other countries and the rapidly expanding research field of behavioural economics.

The freedom of choice in the system regarding provider rests with the employers, who procure the pension provider. The National Employment Savings Trust (NEST) is a provider financed by the state that is obliged to accept all employers that want to become customers. In all other respects, NEST competes with other providers on the auto-enrolment market. The state's introduction of a low-price provider resulted in that the general cost level for occupational pensions has been falling.

The previous insurance solutions in the UK, often involved large open fund platforms. Distribution took place via independent financial advisors, who used the fund platforms as tools for constructing investment portfolios for their customers. The auto-enrolment reform resulted in the market becoming simpler for customers, eliminating the need for advice and reducing costs. The new providers on the occupational pension market offer much simpler products. NEST offers no fund platform; instead, it has a default choice and a few solution packages, with 98 percent of savings capital remaining in the default choice. It is worth noting that there is also a commercial provider that only offers a default choice without any selectable alternatives.

2.4 Summary of international experience

Developments in the funded occupational pension solutions in Australia, Chile and the UK demonstrate an interesting trend. In Australia, the complex product offering of the occupational pension led to strengthened supervision, regulation of financial transparency and the introduction of transfer rights so that savers could reject sub-par solutions. This laid the ground for an advisory market, which made the choices on behalf of savers. To resolve this problem, the trend it to move towards more clearly standardised products for the default choice, and there is consideration of moving towards an institutional market for default choices.

In Chile, competition did not lead to the expected pricing pressure but rather to high costs for savers. Although the auction process led to lower costs, savers continued to show a low level of interest in transferring their savings.

The UK learnt lessons from the experience of other countries in terms of the behaviour of individuals when faced with choices. They opted for an occupational pension system where many of providers are offering limited alternatives for individuals – a default and a few solution packages.

These examples describe systems that are different in design and operate in another environment and culture. However, there are substantially similar experiences in terms of how individuals act, or do not act, and how the advisory market expands when the system becomes too complex. The conclusion from international experience is that freedom of choice should be limited, and systems should be adapted to how people *actually* act rather than being based on how it is believed they *should* act. Transparency and additional information is not particularly helpful when there is neither interest nor desire among savers.

2.5 The market and freedom of choice

For a market to work well, buyers and sellers must have roughly the same information. To protect consumers from unsuitable products and monopoly pricing, the state is responsible for the market rules and implements regulations when needed to strengthen the position of consumers. This is particularly important when the products involved are complex and when consumers have less information than the market's suppliers.

These market mechanisms work well for most products, but for pensions there is clearly a problem. People are rarely interested in voluntarily saving for a pension. Australia, Chile and the UK have therefore introduced legislation making it mandatory for employers to offer an occupational pension. In Sweden, the state pension is compulsory and occupational pensions are regulated in the collective agreements. The lack of interest in saving for a pension is explained by our human nature. We prefer to consume now rather than in the future. A pension is something that most people do not think about until they turn 50. To avoid poverty among the elderly, it is a good idea to make saving for a pension mandatory. It may be overly optimistic to hope that individuals will actively engage in a pension savings solution that they have been forced to buy in the first place.

In the 1970s, Stanford University conducted what is now known as the marshmallow test. The experiment examined how four-year-old children acted when faced with choosing to refrain from eating one marshmallow on the table in front in order to get two marshmallows later on. Pension saving might be said to be a type of marshmallow test for adults, where they must refrain from consuming today in order to consumer more in the future as a pensioner. Because we know that some individuals will not manage to refrain from spending today and will consequently not save for their pension, the state forces everyone to save, either as part of a state pension or a mandatory occupational pension. It is regarded as reasonable both to help individuals who would otherwise not have any means to support themselves when they stop working and for the state who still need to provide for them.

The field of behavioural economics is trying to understand the psychology that leads to the different choices individuals make. The basic idea is that we, as people, are exposed to a number of 'biases'. This is nothing new; various kinds of sellers have exploited such biases for millennia's. One of the pioneers in this field of research, Daniel Kahneman, claims that it is difficult for us, as individuals, to avoid biases, but as a society and institutions we can create structure that will help us address these biases. One might see state-ordered mandatory savings, such as those in the premium pension, as something that helps individuals address their biases and not saving for their pension.

As part of compulsory pension savings, Australia and Chile have tried to get individuals to choose between different pension product providers. Even when these products are standardised and easy to understand, it appears that consumers do not use their freedom of choice. This behaviour results in that the market forces are being taken out of play and competition do not lead to better products at lower prices. When the product range is complicated, advisors find business opportunities by helping consumers, but since these advisors often receive commission from providers, the advice given does not always reflect the best interests of consumers. A lack of interest is often attributed to insufficient information and decision support systems, but experience has shown that greater transparency and education only have a marginal effect. The fundamental problem is that consumers are not interested in micro-managing the content of compulsory pension savings themselves.

The premium pension has taken things even further, with own choice meaning that individuals are expected to decide on the portfolio construction, sector and region allocation, select mutual fund providers, and continually evaluate and monitor their portfolio.

Research also shows that more choice options leads to fewer people actually making a choice. In 2000, psychologists Iyengar and Lepper published an experiment that showed that a wide range of options generates interest but that it can also prevent individuals from making a choice. An upmarket supermarket had a stand with 24 varieties of jam. People received a discount voucher if they tried one of the jams. 60 percent of customers visited the stand, but only three percent purchased a jar of jam. They later repeated the experiment, the only difference being that there were now six varieties of jam. 40 percent of customers visited the stand, and 30 percent purchased a jar of jam. With regard to choices in the premium pension system, it may be the case that the current large range of mutual funds is putting off some those people who are genuinely interested in making a choice from actually doing so. In 2016, only five percent of pension savers in the premium pension changed mutual funds.

2.6 Findings of research projects

The beginning of this chapter described the black boxes in an airplane that record the data of the flight and the cockpit conversation. All the data from individuals' choices are stored in the Swedish Pensions Agency's data repository, but how could we obtain information explaining why those particular choices were made? This inquiry, commissioned four research groups to better explain the choices of individuals. Projects A, B and D were based on the Swedish Pensions Agency's data repository and Project C was based on a survey that tried to obtain answers about what drives individuals' decisions.

Project A:
How many types of fund are needed to provide sufficient freedom of choice?

Anders Stenkrona – Stockholm University

The research project aimed to investigate whether the portfolios chosen by individuals for the premium pension can be explained by a few factors: building blocks – simplified asset classes broken down into sectors. The aim was to investigate how many building blocks were needed to achieve the freedom of choice currently utilised by individuals in the premium pension. Preliminary findings:

- Between 90 and 93 percent of the variation in historical outcomes from the 867 funds that currently exist in the premium pension system can be explained by seven building blocks.
- Between 94 and 99 percent of the capital in savers' portfolios is allocated to these seven building blocks.
- There is a clear link between the offering of a building block and the savers allocation of capital to that building block.

There are many similar mutual funds on the fund platform. The preliminary findings indicate that it is possible to trim the numbers of mutual funds without significantly affecting individuals' opportunities to diversify their portfolio. It also seems like the supply drives the demand with regard to these different building blocks. The conclusion is that it is possible to provide a fund platform with a very limited number of fund categories without significantly restricting the individuals’ opportunities to take investment risk.

Project B:
Is there a link between financial literacy and the choices that individuals have made?

Madeleine Moor-Larsson – London School of Economics and Political Science

This project aims to examine if there is a link between individuals’ financial literacy and the choices they have made in the premium pension. Does a greater ability to understand financial information lead to individuals making different premium pension choices?

Academic literature often uses the level of education as the strongest explanatory variable when it comes to assess in an individual’s ability to understand financial information. The number of active choices made by individuals over the period 2000–2016 is used to classify individuals’ level of selection activity. The lowest selection frequency is no choice (default choice throughout the period) and the highest frequency corresponds to one active choice a year, or more, on average. Preliminary findings:

- With regard to education level, an individual with the highest level of education is twice as likely to belong to the group with the highest selection frequency compared to an individual with the lowest level of education.
- The equivalent figure regarding income level is eight times more likely.
- It is clear that individuals with a higher selection frequency choose funds with higher fees.
- Of those with incomes below the median, 80 percent chose a maximum of once since the start.
- Of those with an income above the median level, 53 percent chose a maximum of once since the start.
- With regard to education level, the equivalent figures are 69 percent and 64 percent, respectively.

The income level accounts for a much larger difference, compared to education level, in selection frequency and mutual fund fees. Education level is usually a better or equal factor to explain individuals’ financial literacy. One hypothesis is that high-income individuals constitute a target group that is of greater interest to advisors and sellers.

Project C:
How does individuals perceive choice and what triggers individuals' choices?

Lisa Bruggen and Monika Böhnke – Maastricht University

In summer 2017, this pilot study conducted a survey comprising a number of questions about the premium pension. The responses to the survey express individuals' own subjective views. Due to confidentiality reasons, it was not possible to link individuals' survey responses with their actual premium pension behaviour. At the same time, we know that less than one percent of new savers make active choices, and in 2016 only five percent of all savers switched funds. The results in brief:

With regard to individuals' expectations about their future pension, many more are pessimistic than are optimistic. Those with optimistic expectations more often have a high income, consider themselves financially literate, have a high level of education and appreciate having choice in the premium pension. One interesting result is that making choosing mutual funds in the premium pension does not significantly impact on the individuals' expectations about their future pension.

Only a small proportion of individuals believed they had a good knowledge of the premium pension, and almost 70 percent felt unsecure.

Of those who had selected mutual funds, only 13 percent felt well informed when they made the selection. Those who consider themselves well informed are more often younger, men, have an upper-secondary or university education, and believe they have a good level of knowledge and do not feel hampered by having several choices.

The individuals who have chosen mutual funds consider that they have good financial literacy, feel their pension will keep them financially secure, have higher incomes, save more per month, have higher risk preferences, are older and say they appreciate the freedom of choice. Political party sympathy was not a significant factor in the difference between those who chose mutual funds and those who did not.

Of those who chose mutual funds, it was clear that many were not particularly engaged consumers. Almost 40 percent do not know how many mutual funds they have chosen. Less than half know which mutual funds they chose. Almost 50 percent did not know whether or not they had an index fund. However, almost 60 percent knew which mutual fund provider they had chosen. This indicates that more have chosen mutual funds based on the providers' brand rather than on the specific properties of the mutual funds.

In response to the question of what influenced their most recent choice of mutual fund, 30 percent say they were contacted in some way, 30 percent say they were influenced by the media, while 20 percent say they were influenced by the 'orange envelope' containing the details of their premium pension. The remaining 20 percent do not recall.

The individuals that said they had been influenced by others when choosing mutual funds consider themselves less financially literate, believe there are too many options, save more per month and are more often women. 55 percent said they had been influenced by a pension adviser or bank contact.

Project D:

Henrik Cronqvist (University of Miami) and Richard Thaler (Booth School of Business, University of Chicago)

Based on premium pension data this project team has analysed behavioural on detailed level and updated earlier research from 2004[2]. The result from research project D will we presented in September 2017 and will then be available in connection to this pilot study on the governments homepage.

2.7 Summary

All systems are designed based on the environment and knowledge available at the time they are introduced. The premium pension is typical example of this. Not much experience from similar systems was available in the 1990s, and knowledge of how people act when faced with choices was also limited. The premium pension system was designed based on the knowledge available at the time and was largely based on a view of rational behaviour by people and a well-functioning efficient market.

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[2] Design Choices in Privatized Social-Security Systems: Learning from the Swedish Experience, Cronqvist, Henrik;Thaler, Richard H, *The American Economic Review*; May 2004; 94, 2; ProQuest pg. 424

As this chapter has shown, there is now significantly more knowledge and experience about how individuals and the market function in the premium pension system and in similar systems in other countries. Based on this knowledge, this pilot study notes that the premium pension system is based on a worldview in which people have perfect information and are able to act rationally. If this were the case, the current design of the premium pension system would not experience any problems. This pilot study also notes that experience shows that providing information to individuals who are not interested is not particularly helpful and it is naïve to assume that this more information will make individuals act as well-informed buyers of financial services. The conclusion of this pilot study is that the state should take greater responsibility for ensuring that the outcome is reasonable for everyone. The design of the premium pension consequently needs to be based on how people act and how the market actually functions – not how they should function according to some economic theories.

3. The need for a goal for the premium pension

3.1 Why is a goal needed?

When the premium pension was created in the 1990s, the focus was on its *purpose* – to help diversify risk and enable excess investment returns on the capital market. But no explicit overall *goal* for the premium pension was ever established as the basis for its design. Instead, there have been various ambitions and targets, which have sometimes been contradictory, sometimes varied over time and not always been explicitly stated. The most common have been the following: the ability to choose according to one's own risk preference, greater knowledge about one's own pension, attractive investment returns, low costs, limited distribution of outcomes and that as many individuals as possible should make a choice. The latter of these was a strong political objective when the system was launched but has since then gradually shifted towards the opposite approach – without any explicit political decision behind it. The problems discussed recently are partly anchored to these original aims, but possibly more so on other circumstances that were never set as targets, such as the number of mutual funds in the system, the emerging advisory market and the abuse of the system. This could be an indication of unclear objectives, but possibly more that the design does not reflect what is intended to be achieved by the system. What has been unclear is, for example, what the premium pension should achieve in terms of risk and return and how this should relate to other parts of the pension pyramid and the social security system. Should income security or maximizing expected returns be the priority?

An example of the lack of clarity is the expectation that the premium pension should generate a good return, a return that exceeds that on the income pension. There is no definition of how this should be measured, but discussions on the topic interpret this as average return, i.e. a measure of the *system's* return. The weakness is that this measure is at the aggregated level. For individuals, however, it always their own investment return and not the return of the group that is of interest. If the average return is just above the return on the income pension, it could be claimed that the premium pension has achieved its purpose. But almost half of savers will then have received a worse return (which is of particular significance if there is a wide distribution). So will the premium pension have achieved its purpose in that case? The objective of a good return is not explicitly stated, but neither is it defined and it is therefore difficult to monitor and evaluate the system in a fair manner.

A major disadvantage of lacking clear goals, or having unclear goals, is that it is not possible to say whether the choices made in the design of the system was right or wrong. The lack of a clear goal makes it difficult to establish a robust investment strategy to achieve the goal. To paraphrase the Cheshire Cat in *Alice in Wonderland*: "If you don't know what you are saving for, any investment strategy will get you there".

Before considering alternative designs that have better properties, there should therefore be a debate about what we want the premium pension to deliver, i.e. what goal it should fulfil.

3.2 Background and outset

When establishing a goal for the premium pension, it is useful to begin from a number of relevant principles. Some key aspects to be considered, before establishing the goals for the premium pension, are presented below.

Fundamental ideas from the preparatory work of 1994

The main ideas regarding the purpose and goal of the premium pension system were established in Swedish Government Report 1994:20 *Reformerat pensionssystem [Reformed Pension System]*, the Pensions Working Group's key report on which the current pension agreement is based. Below are a number of key quotes from preparatory report that reflect the original ideas and intentions about the future premium pension system.

- A pension system with elements of premium reserves has some advantages. It can allow public savings to increase. If the state pension system is structured as a mixed system, i.e. is a combination of a pay-as-you-go and a funded system, there is also the advantage of some diversification of risk. Future pensioners' incomes will stem from two sources, whose returns will be generated in differently (page 191)
- A mixed system has some disadvantages. It could be regarded as more difficult to understand for individuals. It could also give rise to greater dispersion in economic outcomes between different pensioners, as the return on pension capital will vary between different asset managers. In addition, returns typically will vary more widely over time than changes in salary. (Page 192)

- Our assessment, however, is that the advantages of a mixed system outweigh the disadvantages. The above point about savings and risk diversification is important. Also of great significance are the opportunities for more flexible use of the funded means according to individuals' own choice, which is made possible with a premium reserve portion as part of the state pension. (Page 192)
- There may, however, be a reason to slightly restrict the options available in order to avoid unnecessarily high administrative costs. (Page 212)
- The premium reserve system should include both private and state-owned asset managers. In addition, there should be special state-owned asset managers that manage premium reserve money for people who do not actively choose an asset manager. For these state-owned asset managers, averaging of returns should be applied. (Page 197)
- As the insured policyholders will likely differ in their preferences regarding how money is invested in the premium reserve system, a pluralistic approach should be established for the design of such asset management. This means that efforts should be made to achieve a structure in which several different asset managers compete for asset management mandates. This results in good conditions that will ensure that money in the premium reserve system is managed effectively. (Page 226)
- This will mean that contributions deposited within the premium reserve system can be managed by the asset manager in the manner chosen by the insured individual. However, there will be a solution regarding the contributions in the premium for individuals who do not want to make an active choice. These contributions should be managed under the state administration, by a number of different state-owned asset managers. (Page 227)
- We believe that these pension savings should *be covered by partial guaranteed return*. /…/ This could conflict with what was initially said in this section about the rules for the premium reserve system having to be designed to accommodate the establishment of a multitude of asset managers. Given such a conflict, we believe that interest of having multitude of asset management must give way to interest in security. The same applies to the ability of policyholders to actively participate in the management of pension contributions. Similarly, the desire for the rules to be designed in a way that provides the basis for different risk profiles among asset managers is subordinate to the interest in security as well as the differentiation in investment focus.

> However, we believe it is vital to introduce a guaranteed return so as not to unnecessarily jeopardise policyholders' contributions within the premium reserve system, even if this results in the aforementioned disadvantages. (Page 452)

The objectives of the premium pension based on the preparatory work of the 1990s may be summarised as follows: 1.) there should be diversification and smoothing of risk between the income pension and the premium pension, with 2.) an ability to choose between several asset managers, but with 3.) a secure return being prioritised over freedom of choice, and 4.) for those who do not actively choose an asset manager, assets should be managed under state management by a number of state-owned asset managers, where the total return is averaged across the state-owned managers.

As in other countries, the Swedish system was based on the assumption that individuals will be active and acting rationally. Naturally, there was no extensive discussion about human behaviour and how choices should be structured. This is not surprising, as the academic field of behavioural economics was in its infancy in the mid-1990s, and there was limited practical experience of how individuals make choices.

The ideas about freedom of choice should be viewed, based on what was known at that time on of how markets and competition worked. However, freedom of choice does not necessarily need to be interpreted as individuals themselves must design a well-diversified investment portfolio by choosing from a large number of mutual funds with specialised investment focuses and then regularly need to review the portfolio design and evaluating the selected funds against other funds on the fund platform. It is not clear what was intended by freedom of choice, but it is hard to imagine that the preparatory work envisaged the large fund platform of today in which individuals hire advisors to avoid having to make their own choices or the aggressive sales methods that are being used.

Inspiration from the occupational pension

The state pension constitutes the first layer of the pension pyramid, which supports the occupational pension. In view of the state pension's more fundamental purpose and nature, it is reasonable for the state pension not have more financial risk exposure than the occupational pension.

The table below shows that the default choice in all four large collective agreements is a traditional insurance solution. Under the SAF-LO and KAP-KL schemes, it is possible to instead choose fund insurance (mutual fund platforms) for 100 percent of one's pension savings. This is justified on the basis that the state pension provides a stable core, and that individuals can therefore assume financial risk in their occupational pensions. Under the PA03 and ITP schemes, only a certain percentage can be invested in fund insurance; some will always remain in traditional insurance. The labour market partners have chosen, by means of such restriction, to limit the individual's maximum level of investment risk in the occupational pension.

Table 1. Overview of the choice architecture in the four main collective agreements

	Private sector - 'blue-collar' employees **Confederation of Swedish Enterprise/LO Trade Union Confederation**	**Public sector - municipal employees** **SALAR etc./ Kommunal etc.**	**Public sector - state employees** **Public Employment Service/Public Employees' Negotiation Council, Swedish Confederation of Professional Associations, Swedish Confederation of Professional Employees, etc.**	**Private sector – 'white-collar' employees** **Confederation of Swedish Enterprise/Swedish Federation of Salaried Employees in Industry and Services**
Collective Agreement	SAF-LO	KAP-KL	PA03	ITP/ITPK
Selection centre	Fora	Pensionsvalet	SPV	Collectum
Default, company	AMF	KPA	KÅPAN	Alecta
Default choice, product	Traditional insurance	Traditional Insurance	Traditional insurance	Traditional insurance
Constraints on active choice	100 percent may be invested in mutual funds.	100 percent may be invested in mutual funds.	55 percent (2.5 percent/4.5 percent) of the allocation may be invested in mutual funds. The remaining 45 percent is invested in traditional insurance.	In ITP1, 50 percent must remain in traditional insurance. In the ITPK portion of ITP2, 100 percent can be invested in mutual funds.

There is no restriction on risk the risk level in the premium pension; paradoxically, there is a higher risk in the premium pension's default choice through the leverage that exists in AP7 Såfa. Despite the more basic purpose of the state pension, the risk typically appears to be higher within the premium pension compare to the occupational pension.

Since the individual can decide to draw down their occupational for a limited period of time (at least 5 years), there will be many pensioners, particularly among older ages, whose only income comes from the state pension. This means the level and stability of income from the state pension is particularly important for many individuals, as it will be the only pension income in the latter part of the retirement.

It is worth noting that the occupational pension has also undergone significant changes since the introduction of the premium pension. In the mid-1990s, defined-benefit occupational pensions were the norm, and the only individual freedom of choice was to be found in the premium pension. Following the introduction of the premium pension, the occupational pension has also switched to defined-contribution systems, and the various collective agreements include several different fund platforms that can be chosen by the member. In addition to the premium pension, most pension savers now have a number of separate fund platforms, within their occupational pension, each with different mutual fund offerings and fee levels. It is reasonable to assume that only a few individuals conduct a comprehensive analysis of their overall pension savings at all levels of the pension pyramid and then optimise a portfolio and select mutual funds based on prices and the offering across all their platforms. The complexity of the combined freedom of choice within the pension pyramid could also lead to that even engaged individuals refraining from making choices, known as choice overload in behavioural science. Restructuring occupational pensions into a funded system has meant that the intended purposes of the premium pension – to be able to influence one's pension and achieve risk diversification – have also become possible in the occupational pension system and should also be borne in mind when considering goals for the premium pension.

Goals, long-term approach and portfolio design

The goal with the savings governs how the investment portfolio should be composed. A portfolio whose goal is to provide a stable pension income has a different composition from a long-term savings portfolio. This does not mean that one is better than the other, as the two portfolios have different objectives – one is to generate a pension income while the other is intended to build up a savings capital.

Currently the regulation covering the premium pension contain the requirement that all funds on the fund platform, including the default choice, must be UCITS-registered and offer daily trading in units. Requiring daily liquidity limits investment opportunities, as all illiquid and unlisted assets are automatically excluded. This restriction contrasts with the investments opportunities proposed for the buffer capital in the income pension. Swedish Ministry of Finance memorandum (ref. Fi2017/02972/FPM), *Ändrade regler för Första–Fjärde AP-fonderna [Amended rules for AP1–AP4 funds]*, which is now being circulated for consultation, contains proposals for a framework in which up to 40 percent of the buffer capital can be invested in illiquid assets, with the reasoning "*The purpose of these changes is to make the investment rules more effective to provide better conditions for the AP1–AP4 funds to achieve the goal, which is to maximise the long-term return in relation to the risk in investments, particularly in the prevailing low interest rate environment.*"

As with the buffer capital, the premium pension has a long investment horizon, as it comprises long-term savings for pensions. So, it is important that the capital within the premium pension can benefit from this long-term investment horizon. It is therefore more important that individuals can benefit from the risk premium that is provided by investing in illiquid assets than having access to daily trading on the fund platform.

Who bears the consequences of financial risk-taking in the premium pension?

A very bad outcome in the premium pension for an individual could lead to that his/her overall state pension being less than the level of the guarantee pension. It might be asked whether this is reasonable in a state pension system. This could also force costly compensations. The income pension has a rebalancing mechanism ('break') that is applied when the balance ratio is too low. When this brake has been activated, previous governments, both right- and left-wing, have compensated pensioners through targeted measures outside the pension agreement. It is not unreasonable to assume that future governments will choose to compensate those individuals who receive a poor outcome from their premium pension. There are consequently economic reasons for the state to ensure a design that increases the likelihood that outcomes will not be excessively poor.

3.3 Principles for formulating the goal

The existence of a clearly established goal for the premium pension is naturally of great significance for the design of the premium pension system. The premium pension is a mandatory state savings system and part of the social security system. The state should therefore have overall responsibility for the entire system and a particular responsibility for managing the mandatory contributions in the premium pension for those savers who do not want to, or cannot, choose their own mutual funds. Most individuals, and particularly inactive savers, are likely expecting this to be the case.

On the other hand, if there is no clear goal for the premium pension, its design is not determined politically. The design of the default choice, for example, will be determined by AP7 instead of based on a political trade-off. This could be regarded as a less appropriate delegation, as consideration of objectives not only relates to expected investment returns but also the degree of security, risk and stability the system should have and the interdependence with to other parts of the pension and social security systems. This relates to the foundations of the pension system and should therefore be a political trade-off, not an issue for authorities.

The fundamental question is how to view the interaction between the income pension and the premium pension in the pension pyramid. One approach is to view this as one system with two components and optimise the expected return of the system based on how the component covaries, this leads to different goals for the two components. Another approach is to apply a robust system approach in which the two components are viewed as independent parts but sharing the same objective, with only the funding being different. In the first case, the premium pension assumes greater risk, taking account of the lower risk in the income pension. In the second case, both systems independently aim for the same objective reflected in the social security system.

The purpose of the social security system is to provide financial stability during periods of life when one has insufficient provision through one's own work. A goal for the premium pension should therefore be in line with the ambition of providing basic financial security, which is the purpose of the social security system. This means that those who do not wish to or are unable to choose should feel secure, knowing that their premium pension is being managed prudently throughout their lives without requiring any engagement. Those who make a choice should feel that can make their choices in a quality secured environment. A choice architecture for the premium pension must take the goal into account.

Given that the premium pension and the income pension are at the same level in the pension pyramid, this pilot study recommends that a robust approach be adopted whereby the income pension and the premium pension are regarded as two independent components leading to that the premium pension should be regarded as a fully funded 'sibling' – i.e. having the same purpose and goal but with different forms of financing.

As the premium pension is at the level of social security, it is especially important to establish the level of risk. The purpose of the social security system is to build up a *stable lifelong pension income* for individuals, which is not the same thing as building up a *stable pension pot*. The mandatory state pension aims at basic income protection on which occupational pensions and possibly additional private savings are built. A solid base in the pension pyramid makes it possible for the labour market partners and individuals to plan the other levels.

Risk, however, is ultimately borne by savers, so the state's responsibility should not be interpreted as a guarantee of pension outcomes. The state's responsibility instead involves acting to ensure responsible asset management, so that the expected outcome is better than the income index without taking excessive financial risks.

A fundamental idea since the inception of the premium pension has been that it should be possible for savers to choose the level of risk and to influence how their funded capital should be managed. Based on the state's responsibility and the individual's limited interest in choosing, the need for freedom of choice could be questioned, particularly since the 1990s, significant freedom of choice has been introduced in the occupational pensions at a higher level in the pyramid. However, there is a group of individuals that is interested in making choices themselves. Combined with the original purpose and the fact that freedom of choice is already established in the system, this suggests that there should be some form of freedom of choice in the system.

The degree of freedom of choice has never been defined. The preparatory work spoke about a variety of different asset managers but also about security being prioritised over freedom of choice. As mentioned previously, the state should ensure a secure solution for those who cannot or do not want to choose. To the extent that there should be choices for this group, it is particularly important that the alternative choices meet the same basic criteria as the default choice. Even if there should be broader freedom of choice whereby individuals choose the level of risk themselves, the state should take responsibility for ensuring that the choices are secure and in line with the objective of the premium pension.

Based on what has been said above, this pilot study believes that the following criteria should be included when determine the goal for the premium pension and therefore guide the design of the premium pension system:

1. The premium pension is a compulsory social security system for which the state has overall responsibility.

2. Investments should prioritise insurance before savings and target a stable lifelong pension income.

3. Over time, returns should exceed the income index.

4. For those who are interested, there should be the opportunity to choose from quality-assured alternatives.

5. Risk in the premium pension should not be higher than in occupational pensions.

In this pilot study, the objective of the criteria proposed here is to narrow down the key features when discussing the alternative designs in the next chapter. The precise details of the design should be considered in further work to be undertaken after this pilot study.

3.4 Some conclusions based on the criteria

The premium pension is, as mentioned, mandatory and determined by the state, and therefore the state should be accountable for ensuring that it is responsibly designed. The state also bears a particular responsibility for ensuring that those savers who cannot or do not want to make a choice themselves will receive a reasonable outcome without being required to take action themselves. Having a goal for the premium pension is therefore particularly important for this group, and the design of the default choice should be entirely governed by the goal.

Based on the above criteria for a goal, the default choice should, over time, deliver an annual return which is higher than the income index. Achieving a good return involves taking financial risk. However, the guiding principles are stability and lifelong pension income. Higher risk means the expected return will be higher, but the downside is that the risk also means that the actual return could turn out to be lower than the income index.

One way to manage this is to use *generation funds*, which adjust the risk level based on the number of years remaining until expected pension age. A young individual has a long investment horizon ahead and can therefore take more financial risk with their contributions, as they have time to sit out any losses and they will continue to contribute for decades before they draw their pension income. An older individual with only a few years left until retirement would find it harder to cope with financial losses in their relatively sizeable premium pension capital since that person will not pay to many more contributions before retirement. Many providers have translated this basic rule of thumb into generation funds. When young, an individual only has equities in their premium pension savings. As they grow older, the equities are gradually replaced by nominal bonds according to a predetermined table. As they approach pension age, the individual has a large portion of nominal bonds with long maturities in their portfolio.

The problem is that the automated approach of a generation fund is based on strong theoretical assumptions, such as investors being rational and not influencing one another, which leads to efficient financial markets. In such a theoretical world, there would not be a significant difference between building up a pension pot (savings) or building up a lifelong pension income (insurance).

But in practice, the global economy and financial markets involve complex interaction between individuals, the same individuals who cannot, or do not, want to choose mutual funds on the premium pension platform. The financial markets are therefore relatively unpredictable, even in the longer term. Financial bubbles and the following crises is part of life. There are different economic regimes and they may endure for decades. Since the 2008 financial crisis, we have been in a low interest rate environment with high equity and property valuations. This regime could continue for many more years, or it may not. During periods with low real interest rates, it is expensive to convert a pension pot to stable, inflation-protected pension income, but during periods of high real interest, the same pension pot generates much higher inflation-protected pension income. In practice, this results in differences in investment strategy between maximising a pension pot (savings) and building up a lifelong pension income (insurance).

The disadvantage of a generation fund is that its automated structure does not take account of how the financial markets are performing. There is an automatically triggered transition from equities into nominal bonds when an individual reaches a certain age, regardless of how current state of the economy or what the forecasts of the future are.

Another strategy takes inspiration from *traditional pension insurance*. The key features of traditional insurance are that there is a guarantee and that the insurer provides asset management service for the insured. In traditional insurance, therefore, individuals do not have to design a portfolio themselves, select funds or have a view of how the financial market might perform. The objective is deliver stable returns in excess of the income index. The guarantee provides security of last resort, a floor for future pension income.

However, an absolute guarantee cannot be given. This would conflict with the pension agreement, as a guarantee could pass on costs to the state budget. But a solution with a brake, as in the income pension, could be applied as a safety mechanism if the system becomes unbalanced. To manage the generation issue, this strategy could also be grouped into different age categories to avoid transfers between generations.

There are positive features in both approaches, and there are grounds for taking inspiration from both of them. One advantage of combining generation funds and traditional pension insurance is that the capital can be managed more dynamically based on prevailing market conditions and market valuation levels. In addition, the guarantee emphasises building up stable inflation-protected income over time. A consequence of this could be that the organisation managing the default choice looks for investments in illiquid assets that has stable real cash flow.

In the absence of a goal for the premium pension, the focus of the debate about the premium pension has generally been on the pension pot rather than on a stable lifelong pension income (insurance). As a consequence, the discussion has naturally tended to centre around switching mutual funds at the right time, to be actively involved and make the right choices among a large number of mutual funds. It is not only the long investment horizon that is typical of pension savings – there is also insurance against achieving very old age and, therefore, having a stable life-long pension income. A stable pension income with a focus on insurance, as described above, has a different investment strategy from pension assets with a sole focus on a pension pot.

To conclude, key objectives such as security, stability, guarantee and pension income, rather than maximising the pension pot, should result in another type of design, particularly for those who do not choose. Following this approach, the default choice would be designed differently compared to the current default choice by AP7. There would be a greater focus on a stable inflation-protected pension income instead of trying to maximise savings. The current default choice has substantially higher risk. Higher risk in investment typically generates higher returns on average, but there is also greater risk of worse outcomes in relation to the income index. Switching the focus to a more stable pension income means giving up some of the expected excess return in exchange for more stability. This pilot study believes, however, that the default choice of a social security system should reflect robustness and security. This is also the model chosen in for the default choices in the occupational pensions, and it is reasonable that the default choice in the premium pension should not have a higher risk level.

4. Alternative designs based on a goal of stable and secure pension income

4.1 Key considerations in choosing alternatives for action

A significant conclusion in previous chapters is that the state, which introduced the premium pension, should take clearer responsibility for both the design and expected outcomes. The premium pension is part of the state pension. A state pension exists in part so that the state can ensure that people are saving enough for an adequate basic pension, avoiding that future generations must carry the burden of insufficient savings. The state should therefore also take responsibility for ensuring that the premium pension provides a reasonable expected outcome, particularly for those who cannot or do not wish to choose.

Another key conclusion is that the current design is based on a theoretical model of how people should act and not how they actually act when faced choices. With regard to pension savings, both in Sweden and internationally, experience is clear. Most people neither can nor want to make a choice, and this is not surprising. It is not the fault of the individual – it is the model of how people should act that does not align with reality.

A consequence of this is that the market mechanisms in the premium pension's open fund platform function poorly compared with what the theoretical model predicts, and constant intervention from authorities and the Pensions Group are required. We have acquired an oversized and overcomplicated architecture, with many individuals feeling forced, or being persuaded, to pay for advice to avoid making a selection. This is not cost-effective, and the objective must be to develop simpler solutions that suit people better – to adapt the system to the people, not the other way around.

Based solely on these conclusions and what has been said about the goal-related criteria in the previous chapter, this pilot study believes that the most rational design for the premium pension system would be to manage the entire premium pension in one fund, but with the ability for individuals to choose between a few solution packages that also are composed based on the goal-related criteria.

However, there is another key circumstance that influences the choice of an optimal design, namely that there is already an established fund platform in which a large number of savers have chosen mutual funds and in which many have also made fully conscious and successful choices. To dismantle this already existing platform is such an extensive change and complicated process that it will have implications for what this pilot study recommends as the main track.

This pilot study's main track takes the overall approach of the initially mentioned conclusions about the state's responsibility for a default choice and a secure choice environment designed based on how people act when facing choice. This will apply in particular to the default choice and the limited number of solution packages that the individual can select. Since the fund platform exist, it is reasonable to continue to offer that as an alternative for those who want to leave the secure choice environment and take responsibility themselves by choosing mutual funds. However, in this case, the state should take greater responsibility as owner of the platform to ensure that the quality of the offering and that the overall risk level for individuals is reasonable. This should be regulated through an independent authority, with the authorisation and independence corresponding to that of the AP funds, acting as the principal of the marketplace and procuring cost-effective and quality-assured funds in a professional manner.

This is consequently the main track that this pilot study recommends. To arrive at this recommendation, this pilot study has taken account of the findings of previous inquiries, the research projects within this inquiry, international academic experience, the role of the premium pension within the social security system and the original purposes of the premium pension. By maintaining the fund platform, the main track could to some extent be regarded as diverging from the goal-related criteria, but as a whole the solution is a balance of what is practically feasible without making too many interventions.

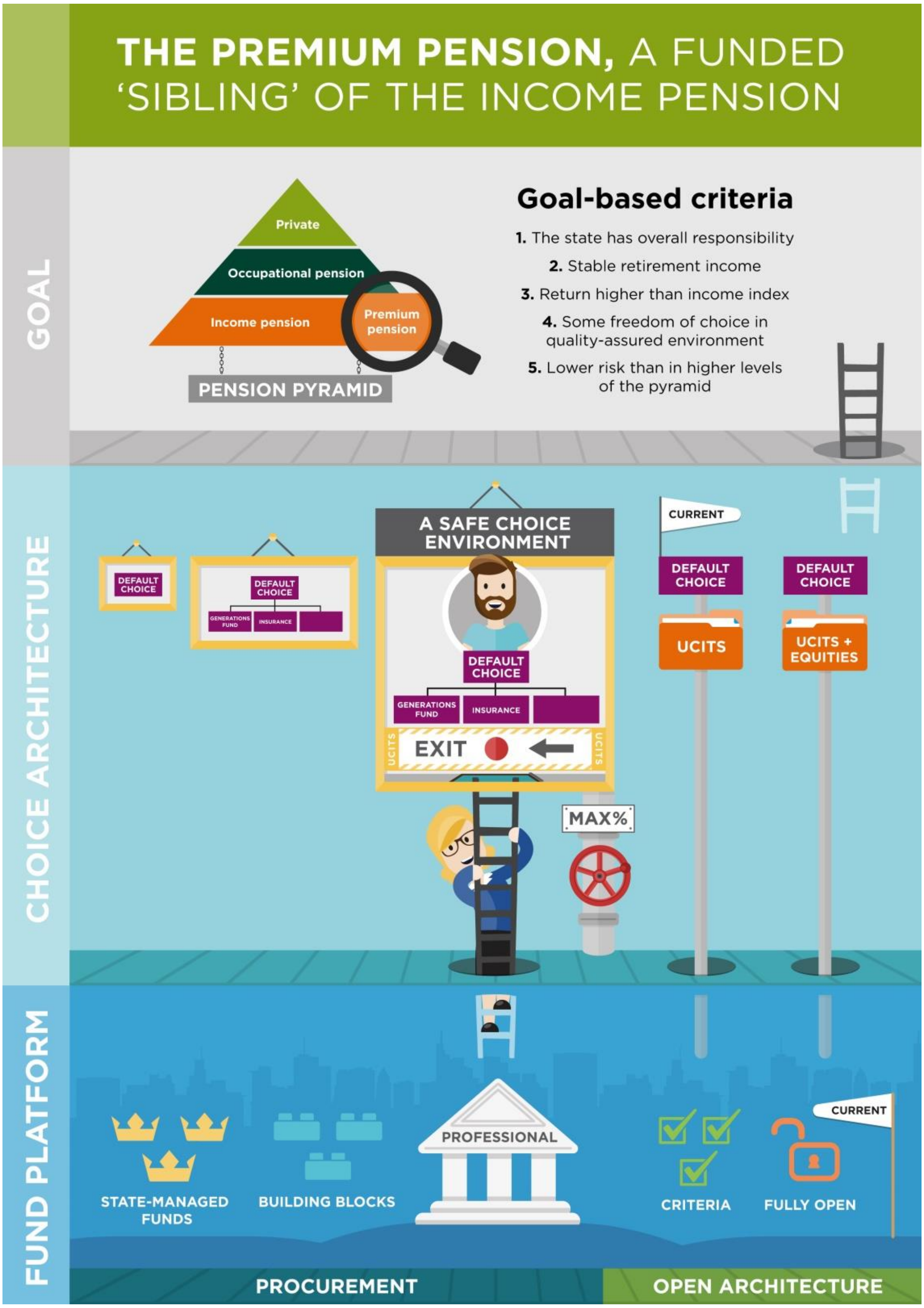
The purpose of the pilot study has been to develop a roadmap for the possible alternatives and outline their implications, and this chapter discusses the main track and the possible alternatives. All alternatives are feasible, but the main track should be viewed as this pilot study's 'default choice' in this roadmap of eligible alternatives. This pilot study presents the design alternatives using an architecture with two levels. The first level contains five different choice architectures for the individuals. Three of the proposed choice architectures contain a fund platform, and in these cases, there is a second level outlining alternative structures of the fund platform including different degrees of openness, offerings and freedom of choice.

With regard to topics such as sustainable investments, there should be a requirement for the entire premium pension system. All providers and mutual funds included in the premium pension system should adhere to a set of ESG criteria decided centrally. As both the income pension and the premium pension are part of the social security system, this pilot study believes it is reasonable to apply the same key sustainability requirements to both the buffer capital in the income pension and the premium pension.

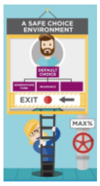
4.2 Alternative selection architectures

This chapter presents five potential *choice architectures*: a main track, two more restrictive choice architectures and two less restrictive choice architectures. An illustration is to be found below.

Potential structures for the *fund platform* are outlined in chapter 4.3.


THE PREMIUM PENSION, A FUNDED 'SIBLING' OF THE INCOME PENSION
GOAL
Private
Occupational pension
Income pension
Premium pension
PENSION PYRAMID
Goal-based criteria
1. The state has overall responsibility
2. Stable retirement income
3. Return higher than income index
4. Some freedom of choice in quality-assured environment
5. Lower risk than in higher levels of the pyramid
CHOICE ARCHITECTURE
DEFAULT CHOICE
DEFAULT CHOICE
GENERATIONS FUND
INSURANCE
A SAFE CHOICE ENVIRONMENT
DEFAULT CHOICE
GENERATIONS FUND
INSURANCE
UCITS
EXIT
UCITS
MAX%
CURRENT
DEFAULT CHOICE
UCITS
DEFAULT CHOICE
UCITS + EQUITIES
FUND PLATFORM
STATE-MANAGED FUNDS
BUILDING BLOCKS
PROFESSIONAL
CRITERIA
CURRENT
FULLY OPEN
PROCUREMENT
OPEN ARCHITECTURE

The main track: A secure choice environment as a base, but with a built-in exit to a fund platform



This type of solution is inspired by the book *Nudge*. It is a hybrid model that combines a secure choice environment with a few solutions packages and allowing those who are interested to compose their own portfolio. The hybrid element of this model has led to it becoming more common internationally in occupational pension solutions.

The default choice is specially designed to dovetail with the social security system and is targeting the goal criteria. Those individuals who do not feel that the default suits their needs can choose from a limited number of solution packages that are also designed to target the goal criteria. What the default choice and the solution packages have in common is that they are designed to work over the course of the individual's lifetime and consequently do not require further decisions from the individual. Typical examples of solution packages that can be chosen include generation funds or variations of the default choice with different trade-offs between expected return and stability in the pension income. Within this secure choice environment, individuals mainly choose between diverse types of strategies, which reduces the risk of extreme outcomes for individuals. Those who feel this is insufficient can choose the exit to the fund platform, but these individuals must be clearly informed that they are leaving the secure choice environment and that they are taking responsibility for their investments and the consequences of this. Individuals can of course choose to leave the fund platform and move their capital back to the secure choice environment.

The advantage of this model is that it aligns with the preferences of most individuals. Those who cannot or do not want to choose mutual funds have a secure choice environment with a responsible default choice. Meanwhile, those who want to put together their own portfolio of mutual funds are able to do so. Combinations are also possible; those individuals who want to add some spice to one of solution packages can move a portion of the premium pension capital from the secure choice environment to the fund platform.

In the default choice or when choosing one of the solution packages in the secure choice environment, individuals should not need to make any further choices before they retire. Within the secure choice environment, it is reasonable for individuals to have some exposure to a broader investment universe that contains unlisted assets.

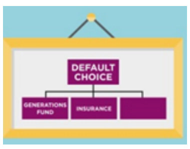
A weakness of this model is that the difference in outcomes can be significant if an individual chooses to move all their premium pension capital to the fund platform. If all capital is invested in a narrow, high-risk investment strategy, the basic problem remains that in the event of poor outcomes the individual will be compensated by the social safety net outside the pension agreement.

Restricting the level of risk in the fund platform is difficult to do in practice, as those individuals who want to add some spice to one of the solution packages can do so by moving a small portion of their premium pension capital to the fund platform. In that case it is justified in choosing a concentrated high-risk investment strategy on the fund platform. A practical way of limiting an individual’s level of risk is to restrict how large a portion of an individual's premium pension capital can be moved to the fund platform.

Under this model, those who choose to use the fund platform could be charged with the cost price when accessing this additional freedom of choice. Those remaining inside the secure choice environment then do not need to cross subsidise the costs related to quality control, oversight and maintenance of the fund platform.

For those who believe the main path provides <u>too much freedom of choice</u> there are two other alternatives: a more restrictive alternative (*‘The two-level model: A secure choice environment’)* and a highly restrictive alternative (*‘The one-level model: The default choice only’).*

The two-level model: A Secure Choice Environment



A more restrictive alternative is to only offer the secure choice environment. Those who do not believe the default choice suits their needs could still choose from a limited number of solution packages. Removing the exit to a fund platform will not significantly limit freedom of choice for the overwhelming majority of the population. International experience shows that with a good secure choice environment only a small fraction of savers would use the possibility to move to a fund platform.

Many individuals value the possibility to have some choices within the secure choice environment even if they choose not to use it. The secure choice environment allows individuals to choose another strategy at some point in the future, so they do not need to feel captive.

From a social security perspective, this model is attractive, as the design allows the solution packages to be linked to the premium pension's role in the pension pyramid. As the safe choice environment only contains well-diversified solution packages, this reduces an individual's risk of facing extreme outcomes in their premium pension. Those individuals who want to make additional investment choices themselves, can do that in their occupational pension.

In brief, this model means moving from a consumer- and provider-driven platform to an institutional market. The secure choice environment will significantly simplify information, administration and oversight. Moving to an institutional market eliminates the opportunities for advisors and unprofessional operators to directly target individuals.

The one-level model: The default choice only'

Not offering any freedom of choice is the most paternalistic form of choice architecture. In this case, the default choice is the only option.

The advantage of this system is that all contributions paid to the system result in the same pension entitlements, but this does not mean that all individuals will receive the same pension income, as individual contributions take place at different dates and each contribution date will have a unique realised return. In this solution, the dispersion in outcomes between individuals, however, is relatively low.

In this solution, individuals neither can nor need to take any decisions. This means that the administrative organisation does not need to take account of capital flows due to transfer of capital, which makes it possible to implement very long-term investment strategies. The premium pension portfolio could then contain a large proportion of unlisted assets. This also makes it possible to implement contrarian investment strategies going against valuation trends in the market.

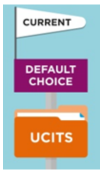
A disadvantage of this model is that the organisation may become complacent and not implement continual improvements to increase quality and reduce costs. Good corporate governance is therefore vital in this model. The current management of the buffer capital in the income pension shows that it is possible to manage this governance risk.

Another disadvantage is that individuals could feel captive, as they are unable to exert any influence – not even by voting with their feet.

An international example of this architecture is ATP in Denmark. They offer a with-profit type of product with the goal to provide a nominal lifelong pension income. It is a traditional insurance product with a low level of guarantee and some profit sharing if the investment portfolio performs well.

For those who believe the main path provides too little freedom of choice there are two other alternatives: a more flexible alternative (*'Fund platform with default choice'*) and a highly flexible alternative *('Fund and equities platform with default choice')*.

Fund platform with default choice (current solution)



This choice architecture is an appropriate alternative if you believe that the majority will, or should, be actively involved in how the premium pension capital is invested. The choice architecture focuses on the segment of the population that actively want to manage their portfolio allocation, select mutual funds and regularly monitor and evaluate their decisions. For those who are not interested in selecting mutual funds, there is a default choice.

Under this alternative, the default choice and the solution packages would be covered by UCITS regulations with daily liquidity, which leads to restrictions on the investment universe compared with the main track.

A disadvantage of this solution is that the association to the foundation of the pension pyramid (and social security) will be difficult to maintain, as the fund platform lead to a framing of a saving pot instead of a retirement income as part of the state pension.

It is possible to reduce the risk level in this model by introducing criteria for allowing mutual funds to participate on the fund platform, which the Swedish Pensions Agency put forward in its ‘30-point programme’.

Fund and equities platform with default choice

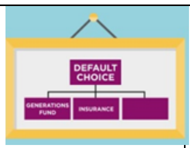
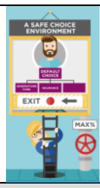
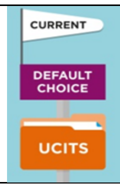
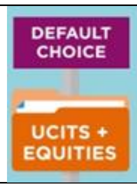
A way to extend the current fund platform with a default choice, involves expanding the investment universe by allowing individuals to invest in individual stocks. This provides individuals with broader set of assets that can be used when building a portfolio.

An advantage of this model is that, by directly owning equities, individuals avoid having to pay an annual fund management fee to a fund manager.

Under this model, the link to the foundation of the pension pyramid (and social security system) is even vaguer, as the premium pension becomes more like a broad savings product for those members of the population who are interested in finance.

To protect the individual and to avoid the abuse of the social security system, this choice architecture will require very strict and complex regulations. This model will also require technical enhancement of the current fund platform.

Table 2. Selection of choice architectures and their features

					
Link to the foundation of the pension pyramid	High	High	Good	Unclear	Non-existent
Focus on goal-related criteria	Good	Good	Good/ uncertain	Uncertain	Very uncertain
Dispersion in outcomes	Low	Medium	Medium/ High	High	Very high
Default choice	Yes	Yes	Yes	Yes	Yes
Assumed interest among individuals / users	Non-existent or low interest	Limited interest in choices	Limited interest but opportunity to choose granted	Large interest in choosing	Very large interest in choosing
Framing towards individuals	Package solution	Package solution	Package solution or components	Mix of components and solution packages	Mix of components and solution packages
Investment universe	Listed and unlisted assets	Listed and unlisted assets	Listed and unlisted assets	Listed assets (UCITS)	Listed assets (UCITS)
Need for risk limitation	Not necessary	Not necessary	Medium	Significant	Very significant
Understandable	Very good	Good	Good/weak	Weak	Weak
Cost-effectiveness	High	High	Medium	Low	Low

4.3 Alternative fund platform designs

Three of the choice architectures outlined above contain a fund platform. In these cases, it is necessary to determine what degree of freedom of choice to give individuals on the fund platform. When prioritising between different structures of the fund platform, it is important to consider both experience from the current fund platform and international experience of how individuals make choices and how market mechanisms have worked. It is also a trade-off between the offering of the platform, quality assurance of mutual funds, costs and the risk of individuals being exposed to unprofessional operators.

The most important choice is that between an *open platform* as used in the current fund platform or a *procured model* as recommended in the main track. This pilot study recommends a procured model, as it contains a clear principal who is responsible and accountable for the fund platform. This pilot study believes that the principal of the fund platform should apply at least the same minimum requirements as in existing regulations covering retail financial services.

In addition to the main track, there is a description of two more restrictive proposals and two less restrictive proposals of fund platform design.

The main track: a professional fund platform

The main track is inspired by the commercial fund platforms in the market, such as those in the occupational pensions. A professional fund platform has a principal who is responsible for the content on fund platform. In contrast to the current fund platform, having a principal in place means that the state take a clearer responsibility for the content on the platform.

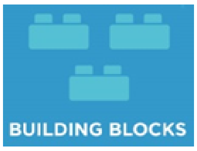
A special body with a mandate similar to an AP fund is tasked, in the same way as the professional fund platform of e.g. a bank or insurance company, with taking responsibility for a procured range of mutual funds. Their task is to select the best mutual funds on the market and to provide quality assurance and regularly assess the mutual funds on the fund platform. This provides individuals with quality assurance when choosing among different funds and providers on the fund platform. There is no absolute guarantee that unprofessional mutual funds will not be able to enter the platform, but it significantly reduces the likelihood of this. It also addresses the problems that the Swedish Financial Supervisory Authority has identified with the current fund platform.

The principal responsible will aim to offer a wide-ranging and effective fund platform with quality-assured mutual funds. The range or mutual funds will initially be the same as on the current fund platform, but will gradually change. By steering on fund categories and procuring mutual funds in these, will prevent there being numerous very similar mutual funds. This will make it possible to gradually reduce the number of mutual funds without restricting freedom of choice for individuals. The approximate number of mutual funds to be included on the professional fund platform is a business decision based on demand, benefit to savers and quality control costs.

The advantage of a professional fund platform with procured mutual funds is that it makes the fund platform more manageable, and mutual funds on the platform can be replaced when the need arises, without requiring political decisions by the pension group.

For those who feel the main path provides too much freedom of choice there are two more restrictive alternatives: *'Building blocks: an institutional package provider ' and 'State-managed funds: an internal asset management model'*.

Building blocks: an institutional fund-of-funds



Under this alternative, the fund platform acts as an institutional procurer of asset management services and offers savers a number of building blocks in the form of diversified regional and sector-based funds, for example. This is a solution whereby pension savers choose between a few building blocks. The fund platform acts as a packager for the building blocks, and each building block is a fund-of-funds comprising of several procured external fund managers.

Alternative 2 of Engström's inquiry is similar to this model. The findings from research project A (Chapter 2.6) show that it is possible, using a few building blocks, to provide individuals with broadly similar risk diversification opportunities as with the current fund platform.

The fund platform has a due diligence team that continually procures, monitors and assesses the external asset managers included in the different building blocks. Quality assurance is the same as in the main track. Since this is a packaged fund-of-funds model, individuals are not affected when underlying investment funds in the building blocks are added or removed.

Since a building block is a combination of several professional asset managers, it is diversified across several asset managers, which reduces the manager concentration risk. This provides more stable results compared to choosing a single asset manager within the same investment area as the building block.

The management cost charged by external asset managers will probably be lower than in the main track, as procurement includes an institutionally priced mandate with predictable volumes. In addition, it is possible, as part of a building block, to procure professional asset management that is not normally available on a fund platform.

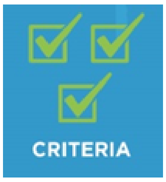
State-managed funds: an internal asset management model

Under this model, the fund marketplace offers a number of state-managed building blocks that are managed by a number of different 'internal' asset management teams. The difference compared to the building block model is in there is an investment organisation in which both internal and procured asset managers are used in the different building blocks.

This leads to an asset management structure that is not entirely unlike the implementation of the buffer funds in the income pension. This model requires a strong corporate governance model with clear directives but could provide cost-effective and high-quality asset management.

For those who believe that the main path provides individuals with too little freedom of choice there is a more open alternative (*'Open fund platform with entry criteria')* and a very open alternative (*'A fully open fund platform'*).

Open fund platform with entry criteria
(Current solution but with 30-point programme)



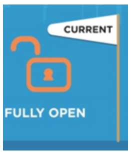
Under this solution, the fund platform is open to all providers of UCITS-registered funds. To filter out unprofessional management companies, the fund platform establishes a number of criteria that mutual funds have to meet in order to be included on the fund platform. The current fund platform, combined with what is known as the Swedish Pensions Agency's 30-point programme, falls under this type of model.

A difference compared to the main track is that this model is based on an open architecture rather than procurement. All mutual funds that meet the criteria are entitled to join the fund platform, and it is difficult to exclude mutual funds that meet the criteria.

Implementing this model requires major efforts in oversight and continuous monitoring to ensure that all mutual funds stays within the criteria after joining the platform. Clear, observable quantitative criteria, such as capital under management, are relatively easy to monitor, whereas a prohibition against direct marketing, for example, is much more difficult to monitor in practice. This will require an organisation that continually supervise the entire fund platform.

A disadvantage of this model is that it benefits large and well-established fund management companies selling their mutual funds via a number of different distribution channels. Smaller but specialised high-quality asset managers could find it difficult to meet all the criteria and would consequently be filtered out automatically.

A fully open fund platform
(Current solution)



The most extreme alternative is to apply a fully open fund platform. The only requirement for a mutual fund to be included on the platform is that is registered as a UCITS fund, i.e. for the mutual fund to be under the supervision of an EU country. This model suits those who believe that market forces, through competition, will lead to self-policing of the platform. That some of saver's will get into difficulties is the price to be paid for innovation and a dynamic market-driven fund platform.

The basic idea behind the open fund platform was that engaged individuals, transparency and competition would to lead to a well-functioning market. Through low barriers to entry for new fund management companies, market mechanisms would lead to that the capital would automatically seek out new, better and less expensive funds. Experience from the occupational pensions solutions in Australia and Chile shows that individuals are not engaged, which means that the market mechanisms did not work as intended.

Table 3. Alternative fund platforms and their features

	STATE-MANAGED FUNDS	BUILDING BLOCKS	PROFESSIONAL	CRITERIA	CURRENT FULLY OPEN
Model	Internally managed (procured)	Procured	Procured	Open platform	Open platform
Principal responsibility	Strong	Strong	Strong	Weak	None
Quality control	Corporate governance	Due diligence	Due diligence	Criteria	None
Bargaining power in relation to external providers	High	High	Good	Pricing schedule	Pricing schedule
Aggressive marketing methods	Not applicable	Not applicable	Can be prohibited in agreements	Can be managed but requires monitoring	Not managed
Risk of fraud	Low	Low	Low	Medium	High

4.4 General comments about transitional rules and implementation

This pilot study has purposely chosen not to discuss how the different alternatives could be implemented or how different transitional rules could be designed. The important thing initially is to first decide on the main direction and then establish the details. It is worth noting that almost all the proposed alternatives are technically possible to implement using the technology used for the current fund platform.

The basis for good implementation is a strong corporate governance model in which the Pensions Group has set a clear goal and given clear directions. This should be managed in the same way as for the buffer funds in the income pension, which are governed by law. This pilot study believes it is important that a future government cannot influence how premium pension capital is invested.

Transitional rules are often sensitive, and it could be difficult to achieve political agreement on these. Under the main track, it is reasonable that the authority responsible for the fund platform would inherit the current fund marketplace and over a transitional period systematically review the current range of mutual funds and prune the excess offering.

Appendix 1. Description of remit

Pilot study of measures for structural changes to the premium pension fund marketplace

Background

The premium pension system serves its purpose by diversifying risk and contributing to higher returns, thereby strengthening future pensions. In recent years, problems have emerged in the form of unprofessional advice and poor compliance by fund companies and asset management companies whose funds are represented in the fund marketplace. In addition, the premium pension's approach to sustainability needs to be updated. Measures are being devised to rapidly ensure that the Swedish Pensions Agency is able to apply high standards for security and sustainability for those funds participating in the premium pension system. Furthermore, the Swedish Pensions Agency's powers to examine whether fund companies and asset management companies are meeting the requirements set in the cooperation agreement are being expanded. But more needs to be done to future-proof the system to ensure secure pensions.

The measures that need to be taken are divided into two parts – immediate measures that make the fund marketplace more secure and measures for structural changes.

The immediate changes will make the fund marketplace more secure and sustainable. Nevertheless, the premium pension system will still contain challenges relating to the choices facing premium pension savers, clarity, supervision, freedom from abuse of the system, protection when receiving advice, management and marketing of funds on the fund marketplace, more efficient administration and management, etc. There is therefore reason to investigate and analyse more structural measures in order to further develop the premium pension to make it easier for savers to achieve the best possible return at the lowest possible fees and other costs, as well as achieving more confidence in the system and secure pensions. To gain an idea of what areas of improvement and what alternative reforms would provide the basis for achieving these objectives for the premium pension system, an initial unbiased pilot study should be conducted. Such pilot study should, at an overall level, describe the areas that require improvement and present alternatives for action.

Remit

The remit is to analyse what areas requiring improvement will remain after the ongoing reforms have been implemented. In addition, there should be a description of how different alternatives contribute to secure pensions and how the premium pension fulfils its function in relation to the pension system as a whole. The proposed measures should contribute to greater efficiency, increased security and a more manageable fund marketplace for both regulatory authorities and savers.

The pilot study should be undertaken quickly and take as its starting point the existing system in Sweden. Comparisons and inspiration may be drawn from international pension systems, existing occupational pension solutions and relevant research. Alternatives that additionally and significantly tighten up the requirements in the 30-point programme should also be considered.

The findings of the pilot study will form the basis of the terms of reference for a forthcoming inquiry or of an agreement in principle on the future design of the premium pension. The pilot study should therefore not contain any final proposals or proposed legislation.

The analysis work should be led by a special investigator appointed within the Government Offices of Sweden. The investigator should work independently but must consult with staff at the Ministry of Finance and the Ministry of Health and Social Affairs. Reporting to the Pensions Group shall take place no later than August 2017. The forms of reporting and any publication shall be determined in consultation with the Ministry of Finance, the Ministry of Health and Social Affairs and the Pensions Group.

Overall schedule

An investigator will be appointed in June. Final reporting will take place at the Pensions Group meeting on 30 August. The Swedish Pensions Agency should contribute statistical capabilities, including some data processing.