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Socialdepartementet
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This note is an independent response for the public hearing concerning *Ett bättre premiepensionssystem (SOU 2019:44)*. The author is a Danish national with substantial experience as an international pensions expert and with significant experience as an independent policy advisor to Governments in a wide range of countries. As such I am an outsider – albeit one with deep insight into the Swedish pension system and Swedish pension policy and politics. I do not have any special interests – financial, political or other - related to the Swedish Premium Pension or the outcome of the current debate.

This reply is motivated by the fact that the issues and challenges considered in the current Swedish debate and in the report are not unique for Sweden. In fact, the same issues are relevant, and the questions are asked – or should be asked - in many other countries seeking to combine mandatory, quasi-mandatory or auto-enrolment based pension savings with individual choice of pension provider.

The starting point

Few individuals have the insight and the time to consider pension issues and make, sustain and continuously evaluate fund choices and product choices. The challenges – as is documented in the report - cannot be addressed through e.g. education and information activities. There is in fact only one way forward, namely to design systems in such a way that the default choice is seen as the norm rather than the exception – by facilitating rather than mandating individual choice - and by respecting the right of all participants to have a strong and attractive benefit outcome regardless of individual insight and competence. In order to do so a strong choice architecture is needed, and the institutional set up must ensure a strong custodianship on behalf of the individual participant as well as the collective of participants.

The report provides strong analytical evidence for these basic views and it provides a strong battery of proposals as to how they can be realized. Looking beyond the

particular Swedish situation, both aspects are of great interest and importance to the international agenda and to other countries. How to make sure, that systems are designed and operated with the individual participant's as well as the collective of participants best interest at heart? How to make sure that elements of competition genuinely benefits participants? How to facilitate and design individual choice when few understand the products offered and few are able to make and sustain an informed choice? How to make sure that fund providers always offer fair deals and are always driven by the best interests of the participants? These questions are key to the new Swedish report, just as they are asked - or should be asked - in relation to pension systems in many other countries.

These and other questions are addressed in the new report. The question that puzzles me as an international expert is why this only happens now, and why it has taken so long to consider these issues? After all, Sweden is some 25 years into the life of the Premium Pension and most of the challenges and issues analysed in the report are well known, and most of them have even been researched before.

Pension systems must be objective driven

The report insists on the important premise that the Premium Pension must be objective driven and that its design and operation must always put participant's interest first. There cannot be any other competing interest to consider – i.e. the need to provide investment capital for particular investments or regional economic development. This premise is not to be taken for granted, and there are plenty of international examples where outcomes are negatively affected or where systems are corrupted by allowing special interests to influence the allocation of investment capital.

At the political level the report establishes an important premise: The state mandates individuals to save in the Premium Pension, and therefore the state must also take steps to ensure the success and attractive outcome of the system.

However, an interesting and important point to note is that this observation does not lead to proposals for a return guarantee or other hard regulation intended to safeguard the outcome. Rather, it compels the report to underline the State's responsibility to ensure clear objectives, prudent management and operation, strong supervision and strong compliance. Also, this observation drives the insistence that system design should meet participants as they are and where they are – not particularly interested, fairly ignorant of financial issues and with more important things to do in their everyday lives.

These considerations are important. Arguably, the popular legitimacy of the arrangement as such depends on how consumer protection is addressed in the absence of a formal guarantee. These assessments should be important reference points in the context of other countries.

Balancing the retirement objective and the concern for free choice:

The report advises that individuals should – as is the case today - be able to make individual choices that are not consistent with the overall objective of the Premium Pension system. This option is provided if the individual moves to the individualised fund choice offered as part of the proposed choice architecture.

The report does not provide an expert view on how the trade-off between pension objective concerns and individual choice concerns should be balanced. Rather it maintains that the balancing act must reflect a political compromise. However, while understanding why viewing this aspect differently may be outside the scope of the report, it may be relevant to point to a potential idiosyncrasy – saving for retirement is mandated as an act of individual responsibility only to be potentially negated through excessive individual high risk taking.

Viewed in an international perspective, this recommendation appears contextual. In fact, the issue - and the preferred approach - may look somewhat different for most other countries. Hence, the Premium Pension is a relatively modest part of a complex multi-pillar Swedish pension system with the Income Pension and the occupational pensions as its dominant elements.

However, it may not be advisable for other countries to adopt the very liberal interpretation imbedded in the Premium Pension if the total replacement capacity of its overall pension system is lower, or if the system in question has a more dominant role in the overall set-up. Indeed many – if not most - other countries may be well advised to balance the trade-off between pension objectives and individual choice differently.

Further consideration may even be warranted in the Swedish case if a fully holistic perspective is adopted. Hence, the occupational schemes are gradually transitioning from DB to DC and the new DC schemes offer extensive free choice – including choice that are not necessarily consistent with the overall objective of the pension system. Arguably this development may change the framework for the assessment, since the risk in the occupational pension increases.

Default choice and choice architecture

Referring to findings from behavioural economics the report makes an important and clear assessment: *“People who cannot compose and manage a well-diversified portfolio should therefore not do so either. They should even less so be encouraged to do so, either directly or indirectly. [...] these people should stay in the default fund.”* This assessment underpins the important basic design axiom that the Premium Pension – and similar schemes in other countries – should facilitate rather than mandate individual choice. Two conclusions follow from this assessment.

Firstly, the default fund must be a well-designed, well managed and attractive professional choice option in itself – attractive even to the most qualified and interested of participants. Secondly, a strong and well-designed choice architecture is needed to support informed and rational choice– e.g. with blocks to prevent participants with insufficient knowledge from making irrational choices.

Touching on the first conclusion, this aspect arguably falls outside the scope of this report as it is the theme of a separate review issued earlier in 2019. Even so, it may be appropriate to recall the importance of this issue and some of its implications. Hence, the default option must be able to take significant investment risk and it must be able to diversify into asset classes and markets as it sees fit to meet its objectives in the best possible way.

This may seem trivial, but it should be noted that in an international perspective this is anything but standard. Some countries insist on default options being low risk with a predominant exposure to national government bonds and other low(er) risk – but also low return – assets. Such policies effectively mean stipulating that failure to make an individual choice should negatively affect pension outcome – thereby implicitly mandating individual choice as a precondition for an acceptable result. Historically, even Sweden has its elements of this type of policy as participants having made an own choice were prohibited from returning to the default fund.

Moving to the second conclusion, the report proposes an elaborate new multi-levelled choice architecture taking the default option as the starting point. Participants can choose a different risk level, they can go even further and choose one or more fund categories, or they can make an entirely individual portfolio choice.

While the proposed structure is elaborate and offers a well-structured answer to the question at hand, it may also seem rather complex and difficult to communicate and understand. Further consideration may be needed on this aspect with the view of making the model easier for the individual to approach.

The report recommends that while the overall framework for individual choice is set out by law, it is left to the operating agency to design, evaluate and develop its detailed design. Leaving considerable latitude to the operating agency on this aspect is important in order to ensure that experiences and new developments can readily inform and affect the implementation of individual choice in the Premium Pension to the benefit of participants without having to go through a lengthy parliamentary process.

Providers should be selected by tender

The report proposes to strengthen the quality of funds and savings products by adopting a tender based model for the selection of funds to be available on the platform. This is an important step because the tender-based model allows the contracting agency to set out separate requirements in addition to the regulatory requirements following from the funds being licensed and supervised. It is also important in order to ensure that choice options align with the objectives of the Premium Pension System.

The alternative – a minimum standards model – as is applied today is likely to lead to a higher number of funds and choice options. However, having a high number of funds is not to a particular quality in itself. More funds is not to be mistaken for more competition and certainly not for better competition benefitting the participants. On the contrary, the existing framework is marked by choice overload. Considering the best interest of the participants, it is a legitimate objective in itself to reduce the number of funds and ensure that the available funds are relevant, of reasonable quality and committed to serving the interests of Premium Pension participants.

AP7 is to undertake tendering.

Tendering for financial services is complex business. It involves preparing, conducting, evaluating and renewing tenders and their results. It requires a clear definition of the objectives guiding the ask and it requires strong insight into how the objectives

can be supported the funds and their operation. Further it requires strong compliance control and systematic evaluation against the standards set out in the affiliation agreement as well as the overall objectives. Also, it requires assessment against standards and models as they develop in the financial industry. The results of this compliance work and research must inform consecutive tender rounds and it plays a critical role in ensuring that the system can remain dynamic and timely.

It follows that a tender based model requires a very strong relatively stable professional team and a strong institutional framework. Following a similar line of argument, the report proposes to allocate this responsibility to the default fund institution the AP7. It also proposes to reshape and rename the AP7 to fit this extended role. The motives for this choice are related to the professional necessities explained above.

It may be argued that this strategy will place the AP7 in a double role being the default provider and being responsible for the tender process appointing its competitors. However, this argument is not strong. The tendered funds serve different roles as they facilitate individual choice rather than provide competition for the AP7.

It may be advisable however, to ensure that the AP7 is closely monitored in its extended role. The main focus may not be to ensure compliance with its new role but rather to ensure that it remains focused and strong in its conduct of this role.

One way to do that is to require that the board of AP7 provides a public report annually which describing efforts undertaken during the year to improve the choice architecture and member outcomes. This report should offer choice statistics and cover behavioural aspects based on academic findings and practical experience on how savers makes choices. This report should be peer reviewed by external experts.

The institutional set up must ensure a strong custodianship

The Premium Pension can be seen as a very large house-hold economy experiment. It offers the opportunity to strengthen pension coverage and financial well-being in old age for the Swedish population. However, it should also be kept in mind that it relates to a highly complex area with a significant time lapse between making the decision and observing the outcomes as well as complex products that are sold to a population with modest financial literacy.

The success of such an effort depends heavily on the provision and undertaking of a strong custodianship on behalf of the participants. A strong custodian agency – or a conglomerate of custodian institutions - is needed to ensure that the system unfolds as intended, that funds comply with the rules set out, that fund alternatives are relevant, that choices remain by and large relevant and that the interests of the participants are always put first.

This is probably an area, where the Premium Pension system has only been partly successful – i.e. the institutional framework has not fully covered this custodianship and both results and a range of recent scandals signify this challenge. Looked upon from an international perspective this “negative experience” is a very important take away from the Swedish case.

The potential observations may be legio: Requiring licensing and supervision may ensure minimum standards, but it will not suffice to ensure compliance with specific rules set out in an affiliation agreement. Consumer driven competition is not efficient in complex financial markets, and it will not drive market discipline. Financial literacy is low, and therefore individual choice may be an inefficient way to enhance welfare if it is not assisted.

When markets are inefficient intervention is required. In order to serve this end, strong custodianship and protection of participant interests are key. The report strongly supports this view and a series of recent initiatives taken in relation to the operation of the Premium Pension are based on the same observation. The proposal to adopt a tender based model and the proposal to assign the responsibility for tendering to the AP7 are strong steps in the process to ensure a strong custodianship. Institutional markets are more efficient than individual markets, and the tender based approach makes it possible to ensure a selection process driven by objective and quality thereby strengthening consumer relevant competition.

The full battery of proposed steps and already implemented recent steps to ensure stronger operation and better outcomes in the Swedish Premium Pension system are important. Not only in the particular Swedish context but also to countries around Europe and elsewhere seeking to build efficient savings-based pension schemes as part of a broader multi-pillar approach.

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