



# Management of the premium pension system

– Cost effectiveness in the best interests of savers

## Background

The premium pension system, in which individuals invest a fraction of their pension contributions in equity funds, mixed funds, generation funds, or fixed income funds, is an important part of the public pension system that is steadily growing in scope and significance. At the end of September 2018, approximately 800 funds were registered on the premium pension's fund market, managing a total of SEK 1,200 billion (USD 131 billion or Euro 115 billion) in pension savings.

The premium pension system is a mandatory form of fund saving that includes groups of savers that may have more difficulty than others in utilising the system's advantages. This applies primarily to those who do not have the prior knowledge and expertise that are needed to make sensible investment decisions. If the system is not effective, there is a risk that these groups will have lower returns from the system and thus lower pensions than other groups. Recently it has also been noticed that there are weaknesses in the management of the premium pensions, weaknesses that have a long-term risk of leading to lower pensions. The Swedish National Audit Office therefore judged it important to investigate whether the management of the premium pension system is functioning as intended. The purpose was to investigate whether the system leads to cost efficiency that is in the best interests of savers. The Swedish National Audit Office has audited the part of the fund management that is handled by private fund companies on the fund market in the premium pension system, which amounted to a capital of SEK 713 billion (USD 78 billion or Euro 68 billion) at the end of September 2018. System efficiency is important, because every pension contribution should generate the maximum

pension for the future pensioners, based on their fund choices in terms of risk, ethical values etc.

One of the most important prerequisites for cost effective management is that the system gives savers access to good information, so as to be able to make informed choices in the pension system. It is also important for the state agencies that are responsible for the system to work to reduce the fees and to focus on monitoring costs in the premium pension system.

## Results of the audit

The overall conclusion of the audit is that the management of the premium pension system could be more cost effective. There are a number of factors that obstruct cost effective management. Our overall conclusion is based on a number of important observations:

### The reporting of costs is incomplete

The responsible agencies, the Swedish Pensions Agency and the former Premium Pension Authority, have certainly arrived at a price reduction in terms of visible charges through the so-called discount model, but the Swedish National Audit Office deems that the so-called discount model does not guarantee cost effectiveness. The reporting of costs that are outside the discount model is not complete. For example, there is no consistent reporting of costs of so called funds of funds. The reporting of result-based fees and transaction costs is also deficient. There are, furthermore, indications that fund managers set fees in relation to the design of the discount model. There are also signs that certain forms of management in the fund market show poor cost effectiveness. This includes, for example, fund management via funds of funds.

It is the Swedish National Audit Office's opinion that the government should investigate the possibility of setting more stringent requirements for fund companies that wish to acgt on the premium pension's fund market to report all costs and to control the cost reporting, as well as determining uniform calculation and financial reporting methods. This would give savers a better picture of the actual costs and fees of the funds, and would also give the monitoring and administrative authorities better possibilities for follow up and evaluation of fund management in the premium pension.

### There are signs of a lack of efficiency on the fund market

The audit report shows that there are indications that the market for funds in the pension system could work more effectively. As a consequence, savers risk paying high charges in relation to the fund performance they receive. One indication of the lack of effectiveness in the

system is that it would have been possible to achieve a higher pension capital using what is known as passive index management. This is partly because passive index management can be done with lower charges. The main explanation for this is well known: a system involving many private producers of different savings products depends on savers being active and making deliberate fund choices. If savers are well informed and make active choices, this leads over time to a “natural clearance” process because savers reject funds whose performance does not match their charges. However, the Swedish National Audit Office notes that there are indications that this “natural clearance” is not working, which in turn leads to the conclusion that changes are necessary in order to improve the system in this respect. The Swedish National Audit Office can confirm that the Swedish Pensions Agency offers information tools for the premium pension savers who wish to choose funds. The purpose of these tools is to make it easier for the individual to choose funds, in the form of a fund selection guide on the Pensions Agency’s website, for example. Although the guide includes information useful to pension savers, it lacks some important parts of information, such as how savings are affected by certain cost items, how fees are set and what management strategies fund companies use.

Another sign of a lack of effectiveness in the system is that fund managers appear to have regularly adapted their charges to the discount model, in a way that is unfavourable for savers. This happened for example after certain fund rules were changed in 2011 which made it easier for fund managers to set higher fees. The audit also shows that the great majority of savers do not react and change fund when fund fees increase. Furthermore, the audit demonstrates that certain forms of management are demonstrably unfavourable for savers. One example is external fund management through fund of funds, which has increased from 4 per cent in 2010 to 28 per cent in 2017, calculated on the proportion of capital administered by private fund managers. A fund of funds has – on average – higher fees and a poorer fund performance than traditional funds.

### The authorities do not focus on assessing cost effectiveness

In spite of the fact that it is within the authorities’ mandate to investigate the correctness of information about fund management costs and how reasonable the level of charges is, the monitoring activities of the authorities do not have a clear focus on fees. Furthermore, it is unclear which state agency has the primary responsibility for monitoring the premium pension. The responsibility for supervision is divided between the Swedish Financial Supervisory Authority and the Swedish Consumer Agency. The Swedish Pensions Agency is not responsible for supervision but is responsible for ensuring that fund management is cost effective. At present, there is no ongoing assessment of cost effectiveness.

It is the Swedish National Audit Office’s opinion that the Swedish Pensions Agency should monitor the charges and costs of the funds over the course of time and should also consider

developing indicators that reflect, for example, changes in charges since this could make informed investment decisions easier. Results of behavioural research into how people choose pension savings show that many savers are not interested in financial choices. This means that they neglect to make choices, allow themselves to be led or risk making quite extreme choices. This raises the question of whether the Swedish Pensions Agency's information responsibility should only be to present the building blocks for a well thought-out analysis of cost effectiveness, or whether the agency should also present the analysis itself.

The audit indicates an unclear division of responsibility between authorities for supervision of the fund managers on the fund market and also that the authorities' tools for achieving cost effective fund management need to be improved. The Swedish National Audit Office can confirm that it lies within the remit of neither the Swedish Consumer Agency nor the Swedish Financial Supervisory Authority to investigate or assess whether business activity on the pension's fund market is run in a cost effective manner.

The Swedish National Audit Office would also point out that foreign funds are not subject to supervision by the Swedish Financial Supervisory Authority. This means that more than half the funds on the pension's fund market are exempted from supervision by the Swedish Financial Supervisory Authority. It is the opinion of the Swedish National Audit Office that the question of primary responsibility for supervision of the cost effectiveness of the fund market could usefully be included as part of the ongoing public inquiry of the future premium pension.

## Recommendations of the Swedish National Audit Office

Since saving in premium pension funds is mandatory, the Swedish National Audit Office considers that the government should, as far as possible, make it easier for the individual to make well-informed and well-grounded decisions on his or her private economy, even though the responsibility for the actual investment decision rests with the individual. This is partly about creating the right conditions for achieving cost effectiveness by means of regulation and supervision, and partly about ongoing assessing cost effectiveness on the fund market. It is also important for savers to have the right tools for facilitating their investment decisions.

The Swedish National Audit Office recommends that the Swedish Pensions Agency (or the authority that administers the premium pension in future)

- develops tools for ongoing assessment of cost effectiveness on the fund market that are aimed at savers, so as to make their investment decisions easier.

The Swedish National Audit Office recommends that the government

- investigates possibilities for setting higher requirements for fund companies that wish to be included in the premium pension's fund market to report all costs
- tasks the Swedish Pensions Agency (or the authority that administers the premium pension in future) with performing regular assessments of cost effectiveness on the premium pension's fund market.