Extract from Ministerial communication from the Ministry of Finance on a new organisation and investment rules for the AP Fund

Summary

Introduction

The main task of the present first–fifth fund boards within the AP Fund system is to act as a buffer within the framework of the National Supplementary Pension System (ATP System). The present sixth fund board has a special function within the AP Fund system – to invest in small and medium-sized enterprises. According to an earlier decision, a seventh fund board in the AP Fund system will manage the funds of the people who have not actively selected a particular pension fund within the premium pension system in the new old age pension system. These assets will be placed in a special fund – the Premium Savings Fund.

This ministerial communication contains proposals for new investment rules and a new organisation for the National Swedish Pension Fund (AP Fund). The proposals have been adapted to the AP Fund's role in the reformed pension system and constitute part of the five-party agreement between the Social Democrats, the Moderate Party, the Christian Democrats, the Centre Party and the Liberal Party on a reform of the pension system. The purpose of the proposals is to create better preconditions for achieving a higher return on pension capital, while limiting the risks by providing greater opportunities for asset diversification. The changes should lead to a more stable pension system. The measures proposed should also help to improve the way in which the Swedish capital market functions.

The sixth AP fund board is not covered by the five-party agreement and will not be dealt with in this ministerial communication. The Government plans to raise this question later by adapting the Sixth Fund Board to the regulations proposed in

this document. With regard to the Seventh Fund Board, the functions approved earlier will be retained. These are not dealt with in this ministerial communication. On the other hand, as part of the five-party agreement a proposal is presented to the effect that it should also be possible to actively choose the Seventh AP Fund within the premium pension system.

It is proposed that the new provisions regulating the AP Funds should be incorporated into a new act on the AP Funds and that this act should enter into force on 1 January 2001. With respect to the proposals relating to the Seventh Fund Board it is proposed that these should enter into force on 1 January 2000.

Distribution of the fund capital

The AP Fund will continue to exercise a buffer function within the reformed old age pension system. The present size of the AP Fund cannot be justified on the basis of such a role. Furthermore, the AP Fund's financial savings will be substantially reinforced by the pension reform, at the same time as the financial savings of the central government will be considerably weakened. For this reason, the Riksdag (Swedish parliament) has approved the transfer of SEK 45 billion in two consecutive years (1999 and 2000) from the AP Fund to the national budget. In addition, under the five-party agreement, a further transfer of SEK 155 billion should be made on 1 January 2001.

In the ministerial communication it is proposed that following the transfers referred to above, the remaining assets in the present first–fifth AP funds should be divided into four independent buffer funds of equal size. Identical investment rules should apply to all four funds. It is anticipated that the assets of each fund will amount to approximately SEK 125 billion.

Organisation

In their day-to-day business the new buffer funds should operate independently of each other and of the Government and Riksdag. Each fund should have a board, which will have sole responsibility for operations. Each board should have nine members and no deputy members. The members of the board and the chairman will be appointed by the Government for a period not exceeding three years. All members shall be appointed on the strength of their personal ability to promote the management of the fund. Two members should be appointed on the basis of nominations from the employee organisations and two from the employer organisations.

Goals for investment activities

The allocation of capital should be based on the undertakings of the AP Fund within the pension system. The management of the Fund should benefit those who are insured. An overriding goal for the new AP funds has been proposed, meaning that investments should be made in such a way as to achieve long-term high returns on capital. The total risk level in the buffer funds and the Premium Savings Fund should be low.

Once a year, each Fund should adopt a business plan containing an investment policy, an ownership policy and a risk management plan. The investment policy should set more detailed targets. These targets should be measurable with fixed time limits. Furthermore, the policy should state how environmental and ethical considerations have been taken into account in investment activities without relinquishing the overall goal of a high return on capital. The ownership policy should set out goals, means, rules on decision-making procedures and general guidelines for matters pertaining to ownership and governance.

Investment rules for the buffer funds

The main principle should be that the funds should be able to invest their assets in all existing instruments on the capital market. Investment rules should be flexible and offer scope for investing a larger proportion of assets in shares and foreign assets than is possible under the present rules.

In effect the buffer funds should only be allowed to invest in financial instruments issued for public trading and listed on the market. This means inter alia that the buffer funds may not grant direct loans or invest in unlisted shares. An exception is made for investments in real estate companies owned by the funds. With a view to limiting risk, the buffer funds are required to invest at least 30 per cent of their assets in interest-bearing securities which have a low credit risk and low liquidity risk.

It is proposed that current investments in instruments which are not tradable and market listed (direct loans) should be transferred to one of the buffer funds (the First Fund) and be wound up separately from other assets. Capital, interest and other means assigned to this Fund for these claims should, after deductions for administrative costs, be distributed equally between all the buffer funds.

With respect to the stock market, the investments of the buffer funds will be restricted to shares in companies whose shares are listed on a stock exchange or other regulated market. In order to prevent the buffer funds from becoming excessively large players and owners on the Swedish stock market, a regulation has been proposed that would limit each fund's ownership of Swedish companies listed on the OM Stockholm Stock Exchange to a maximum of 2 per cent of the market value of all such shares. Certain exceptions to these restrictions will be made for shares in real estate companies.

It is also proposed that restrictions on ownership of individually listed companies in Sweden should continue to apply in the future. This means that a buffer fund may not acquire shares corresponding to more than 10 per cent of the total number of votes in such companies. Certain exceptions will be made for shares in real estate companies.

In order to facilitate sound risk diversification it is proposed that opportunities to invest in foreign assets should be expanded. In order to limit the risk in the buffer function of the pension system, it is proposed that there should be a 40 per cent limit on the proportion of fund assets that may be exposed to currency risk. Foreign assets that have been hedged by derivative transactions are not part of the foreign frame. In the case of equity, the criterion of legal domicile will be applied to determine whether or not there is an exposure to currency risk. In order to limit possible effects on the exchange rate a transitional rule has been proposed which would permit currency exposure to rise stepwise by 5 percentage points annually for a number of years.

In order to limit the Funds' exposure to individual issuers, it is proposed that each Fund may not hold more than 10 per cent of its assets in securities from one issuer or group of associated issuers. An exception will be made for claims on sovereigns and other issuers with corresponding credit risk.

External management

In order to improve prospects for efficient management and evaluation it is proposed that at least 10 per cent of the assets of each fund should be handled by external asset managers. This can be effected through the purchase of shares in funds or through commissions for discretionary capital management.

In- and outflow of assets

Every year, each buffer fund should receive equal portions of the amounts that are to be transferred to the AP Fund system and contribute equally large sums for pensions and other expenditures for the old age pension system.

The Seventh AP Fund

It is proposed that the Seventh AP Fund, parallel with the management of assets belonging to the people who have not actively selected a particular pension fund, should also be allowed to manage the assets of those who have made an active decision to invest their premium pension assets with a government fund manager. These assets should be managed in a special fund – the premium choice fund – separately from the "non-selected" assets in the existing Premium Savings Fund. The same investment rules that apply to private fund management companies will apply to the management of the new premium choice fund. The premium choice fund will be exempted from the requirement of low risk imposed upon the Premium Savings Fund for "non-selected" assets. Following the example of the private fund managers, the Seventh AP Fund should reach an agreement with the Premium Pension Authority about a discount on management services.

Effects on the financial markets

The proposals for new investment rules imply reallocations of the portfolio composition of the AP Funds. Above all, a reduction in interest-bearing securities and an increase in shares are anticipated. On today's integrated international capital markets, changes in domestic supply and demand of this kind should not have a long-term impact on interest rates, share prices or exchange rates. However, in the short term they may have some effects. The AP Funds have the incentive to carry out the reallocations of their portfolios in such as way as to avoid any substantial impact on the markets.

The drop in demand for government securities on the part of the AP Funds will be balanced by a fall in supply on account of the transfers to the national budget (the central government debt will be amortised). The impact on interest on government bonds is expected to be slight.

The AP Funds' demand for housing securities will drop as a result of the new investment rules. On account of the possibility of transferring housing securities as part of the transfers to the Swedish National Debt Office, the impact on demand will be spread out over a long period (7 years), which means that it will be possible to limit market impact.

The proposal for new investment rules also means that the AP Fund will reallocate assets to foreign investments. This could put downward pressure on the krona. However, the proposed transitional rules will limit the risk of any substantial effects.

The reform may also lead to some increase in demand for Swedish shares. However, the proposed limitation rules should mean that any upward pressure on share prices will be limited.

Effects on public finances

The transfers to the central government mean that the government's total balance sheet will shrink. It is estimated that the national debt will be reduced by 11 per cent of GDP over a seven-year period. At the same time, the AP Fund's holdings of government securities will drop, leading to an estimated reduction in the public sector's consolidated gross debt, the so-called Maastricht debt, by 4 per cent of GDP. However, the net debt position remains unchanged.