THE SWEDISH PENSION REFORM

BJÖRN NILSSON

Currently, Björn is Market Director at KP Pension & Försäkring, a Swedish pension fund established by Swedish non-profit organizations and companies. He joined KP in August 2006. During July 2002 – July 2006 Björn was a Senior Consultant at the Hewitt Stockholm office (Hewitt/Löneanalyser AB). His main area was Retirement and Financial Management, being an actuary with a Swedish diploma and having 30 years of experience in the pension business as major selling points. During 28 years before that, Björn held various positions in SPP, Trygg-Hansa SPP, and finally Alecta – the same company under various guises. He was chief actuary, and head of several administrative or business divisions. Moreover, Björn has been the chairman of SIRP (Swedish Institutes of Retirement Provision), and member of the EFRP (European Federation of Retirement Provisions) Board of Directors and also Committee member of International Association of Consulting Actuaries, IACA.
CHAPTER II.

LESSONS FROM THE REFORMS

This paper illustrates the Swedish Pension Reform that took place at the end of the last century, aimed at providing a financially and demographically sustainable pension system. What came out of the process was indeed a National Defined- Contribution (DC) Pension Scheme, though the biggest part is a notional DC Scheme.

How this process came to run so smoothly is the main scope of this paper, with some features worth of observation. There are four chapters: (i) an overview of Swedish Pensions; (ii) the need to change the current status quo; (iii) the new Swedish State Pension: Income Pension and Premium Pension; and (iv) the transformation of the supplementary Occupational Pension Plans.

Lastly, there are some implications concerned with four issues: (i) making sound investment decisions; (ii) the need for an active choice; (iii) timing; and (iv) retirement age.

I. AN OVERVIEW OF SWEDISH PENSIONS

Since early in the 20th century there has been a national flat-rate basic pension for every Swedish citizen – ‘folkpension’. Some employers such as the state authorities and local government provided supplementary occupational pensions on top of that. During the century it became more common for private companies to provide salaried employees (white collar workers) with occupational pensions, but for many employees there was no pension income on top of the National Basic Pension.

In 1960 a National Supplementary Pension came into force after a political process that included a referendum and finally a parliamentary decision. During the voting in Parliament, one member of the parties opposing the governmental proposal withdrew his vote and thus enabled the reform, the introduction of the Allmän Tillägspension (ATP) system, to take place.

Sweden had been ruled for a long period by a Social Democratic government, and it
had always been an ambition of this party to provide a general pension scheme for all. Their bourgeois opposite numbers argued for a non-governmentally constructed solution.

Of importance in the Swedish political landscape are the strong position of trade unions and also a mutual understanding between Swedish traditional industrialists and the employer confederations of the need for cooperation in the labour market. Sweden had been a small export nation whose competitiveness depended on stable production of goods and merchandise. That required a stable labour market situation.

For many decades, collective contracts had existed regarding salaries, working conditions, etc. and finally, during the sixties, regarding occupational pensions. These collective contracts were nationwide and covered large sectors of the labour market – blue collar workers in private companies, white collar workers in private companies, state employees and employees in local communities. Apart from these, there were minor sectors like the banking industry, insurance and others.

Though differing in important aspects, the occupational pension plans had important similar traits for all sectors of the labour market:

i. They were all Defined-Benefit (DB) type schemes and supplemented the National Pension System (ATP).

ii. They required 30 years of service for a full pension level.

iii. They were packages including survivorship and disability pensions, apart from the right to an old-age pension.

iv. Normal old-age pension level was 65 % of salary (including state pension).

v. Standard retiring age was 65.

Financing methods varied from pay-as-you-go systems to fully-funded systems, and employers paid the contributions in all the schemes.

In general, retirement income level used to be 60 – 70 % of final salary (state pension included), and that was the case for some 80 % of Swedish employees – partly due to a high degree of affiliation of employees in trade unions and of employers in confederations of employers, these being the parties in the collective contracts.

In all the general Swedish pensions schemes there were salary ceilings. They are all
related to a Base Amount that is indexed annually, formerly based on the consumer price index. In the National Pension System the salary ceiling was, and is, 7.5 times the Base Amount. Nowadays indexation is based both on the Consumer Price Index (CPI) and on an earnings index. In the Occupational Pension Plans, the salary ceiling for blue collar workers in private companies was the same, but in the other Occupational Pension Plans, the salary ceiling was 30 times the Base Amount. In these schemes, when supplementing the National Pension Scheme, the effect was that the parts of salaries that exceeded the salary limit of the State scheme required higher pension levels – and higher contributions.

It is interesting to note that in one of Sweden’s neighbour countries, Finland, there is no salary ceiling at all in the state pension system, the TEL. The salary of Nokia CEO is covered, as well as the salary of a dish-washer at a restaurant.

II. NEED FOR CHANGE

Due to the construction of the state ATP system, the 30 years required for full pension and a pension level based on the 15 best income years, you did not need to earn the highest possible income for more than 15 years, in order to obtain the maximum ATP pension. This construction favoured those entering the work force late, such as academics. Many blue collar workers, normally starting their careers earlier and working 40 – 45 years before retirement, did not benefit from a long working career. And normally they were less paid than academics and hence might not obtain the maximum ATP pension.

This was considered to be a major problem in the ATP system and required a solution, on top of the weakening financial stability of the system as pensioners are expected to live longer and fewer will participate in the work force – the latter due both to lower birth rates and to later entrance into the labour market due to longer periods of education.

While before the 1960 introduction of the ATP system, there had been a fierce political debate on pensions, a national referendum and finally a very close vote in parliament, there was an astonishing political consensus on the need to reform the system some 35 years later.

A parliamentary working group was formed with a liberal parliamentary member as chairman, Bo Könberg. The group consisted of members from all the political parties, though during the process two parties left the working group.

2 One Base Amount of today equals about 45,000 SEK, 5,000 Euro or US$ 7,500.
Like Bo Könberg, they were all devoted to their task, and considered a broad political backing of a new system to be essential. They started by formulating the problems, as described above, and then invited a lot of experts, politicians and trade-union and employer representatives to contribute with ideas and opinions.

Because of the consensus on the essential principles, the major structure of a new pension system was easily agreed upon.

Quite early on, they concluded that a general rise in the retirement age in order to reduce the financial burden on the system was not politically possible, though it would have been technically easy. This also applied in many other countries, among them another of Sweden’s neighbour countries, Norway.

They also decided that a fully-funded system was not necessary, based on the view that all means for pension provisions must come anyhow from production of goods and services, and hence you cannot, from a macroeconomic perspective, rely on yields from financial funding.

However, a crucial principal to stick to was that pensions should be based on actual contributions to the system, which in their turn should be based on working income. Hence they decided at an early stage on a Defined-Contribuition type of system. At the time however, the notation “DC” was seldom used, and very seldom in later media coverage of the pension reform, though in effect Sweden was to become a DC Country.

Naturally enough, political consensus requires compromises. Among them was the feature that contributions based on income above a salary ceiling did not result in securing pensions, but were mainly just a tax. For most Swedes this aspect is of no importance, but principally – and for high income earners – this was a deviation from the proper way of establishing a system based on pension insurance principles.

Another compromise issue had to do with periods of maternity leave. Since most women took maternity leave, they would not acquire any pension income during those periods and would therefore come off worse in the pension system. Added to that, women generally have lower salaries, which made this an important issue for the “equal rights members” of the working group. So, maternity periods do now acquire benefits in the system.

Guarantee levels and a lot of practical – and important – details of the system required attention, but finally a proposal was formed.

One important detail was the contribution rate, at first agreed to be 18 % of salary,
but later on amended to 18.5% after some further political compromising.

Some issues had to be left for a later parliamentary Implementation Group. Among them were:

i. A technical model for balancing the income and cost of the system over time, so as to retain the financial stability.

ii. The possibility to exchange old-age pension rights for a survivorship pension within the system.

iii. A shift from employer payments of contributions to employee paid contributions.

The first task was successfully engineered by an employee at a former state pension agency, Ole Zettergren, who afterwards spent a lot of time giving presentations of this model.

The other two remaining problem are still more or less unsolved, but recently a new parliamentary working group has been appointed to fulfil the tasks, including some organisational issues of the administration of the state pension system and social security.

Since the introduction of the new pension system, the former regional entities for Social Security management, ‘Försäkringskassan’ in each state subdivision, and the former state agency, ‘Riksförsäkringsverket’, have been transformed into one state agency – ‘Försäkringskassan’. Since the creation of PPM (Premium Pension Authority), the state agency for handling the Premium Pension, the idea has arisen of forming a single agency for administering all state old-age pensions.

When asked the question why the Swedish process went so smoothly, the chairman of the working group, Bo Könberg, names the commitment of political party leaders and working group members and also the great insights of the prime minister and leader of the Social Democratic Party at the time, Ingvar Carlsson.

It was the Social Democratic Party that had once fought for establishing the ATP system and now the leader of that same political party was initiating a radical reform of this very system. However, times had changed in many aspects since 1960, and this same prime minister had also surprised the Swedes some years earlier by announcing the Swedish application for European Community membership, without reservations.
A success factor was probably also that the federation of trade unions for blue-collar workers, LO, has always been a traditional and close supporter of the Social Democratic Party. LO in its turn was in favour of reviewing the state pension system, since the ATP system did not really favour the interests of its union members, the traditional blue-collar workers.

III. THE NEW SWEDISH STATE PENSION: INCOME PENSION AND PREMIUM PENSION

The system consists of two parts: Income Pension and Premium Pension. They are both DC-type systems, and the contributions are 16 % and 2.5 % respectively.

The Income Pension is only a notional DC system. The contributions of all individuals are registered, indexed and accumulated and at retirement transformed into an annuity, also indexed. The transformation algorithm is based on life expectancies and forecasted economic development. The indexation of the annuities is automatically influenced by financial forecasts for the system, and adjusted when buffer funds and projected future system income are not sufficient. The indexation is formally subject to annual government decisions.

The Premium Pension is a pure DC system with full funding. Some 800 mutual funds, UCITS, are available as investment alternatives for all members of the system, but each individual can only pick a maximum of five of these funds. All individual choices are collected by PPM - a state agency - on forms or via Internet, and contributions are invested according to individual choice.

Contributions are collected via the income-tax collection system for employees and employers and forwarded to ‘Försäkringskassan’, which handles the Income Pension, and PPM, for the Premium Pension.

Pensions are paid out by ‘Försäkringskassan’, the state agency described above. The means for Premium Pension payments are provided by PPM, through their trading in mutual funds, while the Income Pension payments are in fact based on a PAYG method.

3 UCITS (Undertakings for Collective Investment in Transferable Securities) are a set of European Union directives that aim to allow collective investment schemes to operate freely throughout the European Union on the basis of a single authorisation from one member state.

4 For further information on the Income Pension System and PPM, please refer to www.ppm.nu, a site on which some of the information is in English. Through that site it is also possible to get in contact with the PPM Information Department, which will happily supply information on details or specific aspects.
There are four parallel buffer funds in the Income Pension system. They are governed by boards appointed by the Swedish government. They operate separately and "compete in delivering good risk-based return on investments". Their purpose is to even out the effects of fluctuating pension payments and contribution payments, and only partly to contribute to funding with investment yield.

Voices have been raised, calling for a merger of these funds to increase efficiency.

Within the Premium Pension system there is a default fund that invests the contributions of Premium Pension members who do not make any active investment choice for their contributions.

IV. TRANSFORMATION OF THE SUPPLEMENTARY OCCUPATIONAL PENSION PLANS

As described above, the occupational pension plans are based on collective contracts that are nationwide or in some cases industry-wide. The transformation of the state pension system required these supplementary occupational pension schemes to be changed. Some of these schemes, especially when they were not fully-funded, also faced the same kind of future problem as the state pension system, and therefore required revision on their own account.

Processes of negotiations between the various parties in the labour market took place in parallel with the process of change in the state pension system, and were finalised at different points in time.

The pension plan “Avtalspension SAF-LO” was established in 1998 for blue-collar workers in private companies, replacing a DB-type, partially funded pension plan, the STP Plan, covering a million members.

Second out was the pension plan for local community employees, PA-KL, with one and a half million members. This plan still kept an element of Defined Benefits for pensions based on salaries exceeding the national pension salary ceiling of 7.5 Base Amounts.

Later the plan for state employees was amended, and finally the ITP Plan for salaried employees in private companies was revised in negotiations concluded in 2006. Unlike the other occupational plans, the ITP Plan transition period from DB to DC is extremely long. Only new entrants into the plan are securing pensions according to a DC-type model, while existing plan members are still entitled to the former DB-type pensions.
A similar contribution rate has been established in all the occupational pension schemes, in some cases after renegotiations. The contribution rate, paid by employers, is 4.5% on salaries not exceeding the salary ceiling of 7.5 Base Amounts and 30% on salaries exceeding 7.5 Base Amounts.

There is no upper limit for contributions, however, in the ITP Plan, where some employees are presumed to have very high incomes, there is an opting-out possibility to be applied jointly by the employer and employee.

The employer also needs to consider the tax deductibility of contributions, restricted to 10 times the base amount for each employee.

Table 1 sums up the pension contributions in the first and second pillars:

<table>
<thead>
<tr>
<th></th>
<th>Annual salary &lt; 75,000 US$</th>
<th>Annual salary &gt; 75,000 US$</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Income Pension</td>
<td>16%</td>
<td>-</td>
</tr>
<tr>
<td>- Premium Pension</td>
<td>2.5%</td>
<td>-</td>
</tr>
<tr>
<td>Total first pillar</td>
<td>18.5%</td>
<td>-</td>
</tr>
<tr>
<td>Second pillar</td>
<td>4.5%</td>
<td>30%</td>
</tr>
<tr>
<td>First and second pillar</td>
<td>23%</td>
<td>30%</td>
</tr>
</tbody>
</table>

There is a good reason for contributions in the higher wage-band to be higher than in the lower band, since funding of pensions in the higher wage-bands normally occurs later in the career and hence contributes less to final pension income.

In the different occupational pension schemes, the reasoning is similar with regard to the number of investment choices available for employees, by contrast with the vast number of mutual funds available in the Premium Pension system. For each occupational pension plan an analogy to PPM is created in the form of an administrative body governed by the labour market parties. These administrative bodies collect individual investment decisions and employer contributions and distribute them to chosen investment alternatives within the framework of the plan. The investment
alternatives are within life and pension insurance companies, unit-linked insurance companies and some pension funds. They are Institutes of Occupational Retirement Provision, according to EU directives, and pay out the pensions.

Table 2 gives the approximate number of employees within the major pension plans:

TABLE 2
EMPLOYEES WITHIN THE MAJOR PENSION PLANS

<table>
<thead>
<tr>
<th>Pension plan</th>
<th>Nº of employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local community employees</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Blue-collar workers in private companies</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Salaried employees in private companies</td>
<td>600,000</td>
</tr>
<tr>
<td>State employees</td>
<td>300,000</td>
</tr>
</tbody>
</table>

SOURCE: PREPARED BY THE AUTHOR.

V. SOME IMPLICATIONS

Due to the transformation of the Swedish Pension Systems we now supposedly have a financially sustainable pension system, supplemented with DC-type occupational pension plans.

In the journey getting there, new kinds of issues have been raised and need to be dealt with.

1. Making sound long-term investment decisions

While in a DB-type pension system, the employer or the state has to consider long-term investment problems in pension funding, while the individual employee member of a Swedish DC-type pension system has to cope with this task with regard to his own pension.

The shift from DB to DC means a shift in the consequences of financial fluctuations and demographical development from employer/state to employee/citizen. While an employer or the state is normally supposed to be better equipped to deal with this

5 A unit-linked life insurance is a contract between a policyholder and an insurance company. In this kind of contact the policyholder assumes the investment risk, is to say moves the financial risk from the insurance company to the policyholder. The insurance company only supports the actuarial risk.
kind of issue, the individual employee normally does not have sufficient means and knowledge. This could constitute a general welfare loss – hopefully compensated by market efficiency.

To make good decisions on long-term financial investments to match future pension payments, you need to understand financial market mechanisms and behaviour to a certain degree. You need not be a financial market specialist, but you need to understand how financial risk relates to expected return on investments, and the typical differences between fixed income investments, stock market investments and other financial instruments.

You also need to understand the implications of your own risk bias, and the possible consequences for your own income level as a pensioner. Most people do not, so a massive educational effort would seem to be essential.

As a matter of fact this was realised by PPM when it was established, and with the joint forces of the media and ‘Försäkringskassan’ a lot of effort was put into supplying good information. However, basic understanding of financial markets requires more than information campaigns. Today, voices are being raised about establishing “financial” education for all pupils in the Swedish school system.

The matter of accepting the responsibility for one’s own pension income meant an important shift in attitude. From a pension system where someone else took care and responsibility, to the new system where this burden was put on the individual, the shift is really important.

However, the need to make decisions about suppliers also became necessary in other aspects of society, including medical care, telephone operators, energy companies and so forth. Many Swedes did not appreciate all the new options and the need to make a choice. And when it came to pensions, the choice was also complicated.

One aspect of the difficulty in choosing is the number of mutual funds available in the Premium Pension system. Some 800 + mutual funds are more than enough, and there is at present a discussion on whether to reduce the number or to keep the vast number.

However there are some difficulties connected with a state agency reducing market offers. What criteria should be used? Management charges? Historical investment performance? New entrants?

In most of the occupational plans, the available alternatives are far fewer, partly due to a desire to “keep it simple”, but also partly due to the fact that the employee
options involve picking out fund-providers (insurance companies etc) from a list, rather than a broad range of mutual funds. Of course this raises criticism from those market players that are not allowed to participate in the competition.

Since management fees are kept low, there is not much room for financial companies or advisers to provide individual advice or support. Instead, effort is put into creating web-based tools to assist in employee decision-making. To a certain extent, some employers are willing to sponsor support for their employees in a new situation of occupational pension options.

A specific type of mutual fund has been created by some fund-managers to make the choice easier, the funds based on age cohorts – ‘Generationsfonder’. These funds are constructed to reduce the financial risk as the cohort grows older and approaches retirement. Picking such a mutual fund principally eliminates the constant need to review the investment portfolio in order to adjust financial risk to increasing age.

An interesting aspect of how to choose between the major alternatives, fixed income and stock market shares, is the fact that for most Swedes the major retirement income will come from the Income Pension – which theoretically generates “return” like a fixed income portfolio. Hence, for Premium Pensions and the Occupational Pension scheme, funds with stock market investments should be picked rather than fixed income, in order to bring total financial risk to a level where the expected return becomes more adequate.

2. The need for an active choice

As in other pension schemes introduced with employee options, the Premium Pension system has seen the trend of small numbers of new entrants making an active choice. This is considered to be a problem.

Unless the very first decision is a strategic one – for instance the choice of an age-cohort based mutual fund – and based on proper knowledge, this consideration is probably also important. Efforts are being made to increase interest in pension investments.

To help guide the PPM in its efforts to provide information and education, research has been done and Premium Pension members have been segmented into groups in terms of attitudes and knowledge. These groups are:

i. “The reluctant passives” (24 %), consisting of members who are not well-off financially, who have difficulty in understanding the information about the pension system and generally do not really trust the system.
ii. “The optimistic passives” (14%) are quite optimistic about the future and do not think it is necessary to engage at present. They feel that pension matters will sort themselves out, since they trust the system in general.

iii. “Those prepared for retirement” (27%), are the older members, closer to retirement and who feel that they are more or less in control of their pensions.

iv. “The pension pessimists” (15%), who are not well-off and believe their pensions will be low. They are not in control of their pensions.

v. “The friends of the national pension system” (9%) really believe in the system and are planning consistently.

vi. “The independents” (11%) are financially well-off, with high incomes, to the extent that their state pensions are of minor importance to them.

For these six different groups, information and tools ought to be designed differently. Some efforts are being made to reach immigrants with genuine language barriers.

3. Timing

It is interesting to observe the financial market situation at the time of introducing a new DC-type Pension System like the Swedish one.

Consider the situation where employees are investing pension money in the stock market and the stock market slumps for a long period. Even though a long-term approach is appropriate when it comes to pensions, negative returns on investments early in the history of a new scheme is not a cause for rejoicing.

When the Premium Pension was introduced, stock markets were rising, but as the first choices were made, the market started going down.

However, Swedes in general seem to understand the long-term aspects of financial investment, or at least there has not been much complaining about the timing. And probably most people understand that the process of introducing a new pension system takes such a long time that any efforts to match market value increases is doomed to failure. You just cannot foresee market behaviour.

As it was, the introduction of the DC-type occupational scheme for blue-collar workers came in just when the market was increasing, while state employees came off worse in this aspect. As regards the long-term results, we just do not know—yet.
One aspect related with co-ordination is the length of time between contribution payments and actual investments. There is pressure on PPM to act faster when an individual choice has been made. However, this is a contradiction of the long-term approach discussed above.

4. Retirement age

The age of retirement used to be a fixed age, typically the age of 65. Former pension systems were of DB-type and pensions were expected to be 65 – 70% of final salary. Private pension savings (pillar III) were enhanced by tax deductibility, and thus the desired higher pension level could be obtained.

Though the stated retirement age was normally 65, the actual average retirement age was lower, about 60. This was possible by using various features of the occupational pension systems to retire earlier than at age 65, with only a marginal reduction in pension level. Employers also paid extra contributions to provide pensions before age 65 in lay-off programs.

Within the new Swedish DC-type framework of pensions, the general retirement age is no longer supposed to 65, but rather the age at which accumulated savings are sufficient to provide the desired pension level, which will vary from individual to individual. Since the new pension system will in most cases provide lower pensions than the former system, it is assumed that actual retirement age will be higher than before.

In such a pension system, longer working careers are favoured and the supply of labour increases. This is in line with state efforts to correct imbalances in the demographic structure due to later entrance into the labour market and lower birth rates.

Little attention has been paid to the issue of raising the current retirement age, though national statistics already show an increase in retirement age. So, even though raising the retirement age was considered politically impossible, the actual outcome of the new pension system will be a raised retirement age, but not the same one for everybody.