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The Premium Pension reforms - the end of the beginning

Pensions in many countries need major reform. In contrast, the 1990s reform in Sweden commands broad consensus and survived the stress test of the economic crisis. Sweden can therefore reform thoughtfully rather than as crisis management. The cross parliamentary pension agreement from December last year does just that.

The premium pension has received attention internationally based on its choice architecture with one default fund and more than 850 funds to choose from. The Premium Pension was unique when it was introduced 20 years ago, and it is still unique in the structure of available options. The mandatory nature and regulatory design of the Premium Pension has created a massive pool of assets that is subject only to limited oversight, so it is not surprising that some bad market practices and frauds have occurred.

The current system in Sweden is based on the fundamental assumption that, with a suitable choice framework, people will mostly make good individual choices about pensions. Developments in behavioural economics, not as well-developed at the time of the original Sweden reform, show that people do not always choose well and explain why. Those theoretical and empirical developments (for which the Riksbank Prize in Economic Sciences in Memory of Alfred Nobel was awarded in 2002 and 2017) have direct relevance to choices about retirement age and about the Premium Pension.

The recently proposed 30-point program makes a good start by providing the Pension Authority with some limited tools to slim down the number of options and remove the worst aberrations. It is basically a filter, a set of criteria, that each fund on the platform must pass in order remain in or enter the platform. This is an important first step but not a substitute for the more fundamental reforms outlined in last December's pension agreement designed to address the deeper problems.

The inherent problem of consumer choice is twofold. Though Sweden does well in international tests of financial literacy, that does not mean that the majority of people can make good choices among sophisticated financial products in a market with complex instruments designed to encourage demand. A separate problem concerns those individuals who could make good portfolio choices but do not devote the time and energy to doing so.

Most people have better things to do in their spare time than developing deep expertise in portfolio construction and manager selection. If most individuals are uninterested, education and transparency will not be enough to transform them into engaged and active consumers on an open mutual fund platform.

Survey evidence suggests that individuals view the choice of funds as a one-off event like buying a car, while in practice it is a continuing process of reviewing and evaluating over the whole of working life. The 2018 paper by Cronqvist, Thaler and Frank makes it clear that individuals in the premium pension did not react to significant changes in a specific fund. The risk profile changed dramatically for AP7, when leverage was introduced in 2010 but almost no-one responded by switching. The highly publicised fraud around Allra should have led to a massive run on their funds, but only 16.5% switched even after Allra's auditor reported the company to the authorities.

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The lack of oversight has led to aggressive marketing and sales practices. The combination of uninterested consumers and an open platform creates obvious adverse incentives. In the absence of well-designed limits in choice architecture many people feel overwhelmed and thus are vulnerable to biased advice. There is a long history of bad outcomes in under-regulated markets where the seller exploits limits in buyer understanding, from 'snake oil' salespersons in the nineteenth century to the 1980s mis-selling scandal in the UK, to concerns about high charges by pension providers in many countries. In that respect the situation is Sweden is entirely what would be expected.

The response internationally has had two elements: tighter oversight and simplification for consumers. The Thrift Savings Plan for US federal civil servants gives members a choice of 5 funds, with a default for those who make no choice. More recently, the UK has introduced pensions organised by the National Employment Savings Trust (NEST pensions), which offer a target-date default fund and a choice of 4 curated funds (higher risk, lower risk, ethical and Sharia). The design of these plans draws explicitly on the findings of behavioral economics.

The proposed 30-point program is only a filter which does not address the inherent problems of the open fund platform in the Premium Pension. There is no one who is accountable for the choice architecture of the platform, nor for assessing the quality of mutual funds. The 30-point program will not change that.

The key challenge is that a large mutual fund platform that is a mandatory part of the Swedish social security system does not have anyone in charge. The strength of the Premium Pension is that it is an *independent* platform with no conflicting commercial interests and thus should be given the power to act as a professional institutional buyer. A more important challenge is that the choice architecture, including the design of the current default fund, needs to be revised so that it better fits with how individuals act in real life.

To summarize, the 30-point program is a good start to addressing the urgent problems in the premium pension, but is only a first step. To paraphrase Churchill, it is not the beginning of the end but the end of the beginning. Demanding work remains implementing the reforms of the premium pension that were outlined in last December's agreement of the pension group. Rightly implemented, this would protect the individual and set a new international standard.

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