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DESIGN AND IMPLEMENTATION ISSUES IN SWEDISH INDIVIDUAL PENSION ACCOUNTS

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Sweden enacted major reforms in its pension system between 1994 and 1998. The new multi-pillar pension system replaced a universal flat-rate pension supplemented by an earnings-related defined benefit tier with a notional defined contribution pension system supplemented by a system of mandatory fully-funded individual accounts. (Both the old and new system have a separate tier financed by general revenues for retirees with low lifetime earnings). Swedes contribute 2.5 percent of earnings to their individual accounts up to an indexed contribution ceiling.

The individual account tier of the new Swedish system tries to avoid the high management fees associated with individual account systems in many countries through centralized management of collecting contributions, switching among the fund options offered by fund managers, and record-keeping and communication with account holders. These functions are performed by the quasi-governmental Premium Pension Authority, which also acts as the sole supplier of annuities for funds accumulated in the individual account tier.

The Premium Pension Authority has been successful—perhaps too successful—in attracting a wide variety of fund managers and fund types to the new individual account system. By the 2004 round, Swedes could choose from among 664 funds offered by 39 Swedish and 47 foreign fund managers. Those who do not make an active choice of funds (Swedes are allowed to choose up to five funds) have their funds invested by the Seventh Swedish National Pension Fund, a quasi-state entity that invests primarily in equities.

The Premium Pension Authority tries to lower information costs for fund choosers by publishing annually a comprehensive booklet with basic information on fund assets, charges, and volatility for all funds participating in the system, as well as web-based information on member funds. Two-thirds of eligible workers made an active choice of funds in the initial 2000 round, which included almost all active labor market participants in Sweden. The Authority has been less successful, however, in encouraging workers in the most recent rounds of fund choice to make an active choice of funds. Over 90 percent of those entering the system in the 2003 and 2004 rounds have ended up in the default fund because they did not make an active fund choice.

The falloff in active choice reflects a variety of factors, some of which—notably low perceived stakes and long time to retirement—can be attributed to the fact that those entering the system in the most recent rounds are overwhelmingly young new labor market entrants with limited earnings and low fund balances. These characteristics also indirectly affected the dropoff: media attention was much lower in later rounds, and there was no "contagion effect" because only a limited part of the population—and a financially unsophisticated part at that—was involved. Fund managers also advertised much less given the limited potential to attract substantial new investments. Finally, the combination of

poor stock market performance since the initial round of fund choice and the fact that the default fund had performed better than actively-placed funds also made an active choice seem less attractive in later rounds.

Among those who did make an active choice of funds, a variety of factors appear to have influenced decisions, notably fund management charges, recent returns in the fund, and a desire to spread risks across several types of funds and fund managers. A small but significant percentage of fund savers have made very risky choices, with a high concentration of assets in specialized funds such as technology funds and Russian equity funds.

Fund switching after initial fund choices have been made has also been very low, despite the fact that unlimited fund switching can be made without charge.

The Swedish system of individual accounts offers a number of lessons for the United States and other countries considering adoption of a mandatory individual account tier in their public pension systems. First, centralized administration of record-keeping, communication and trading functions can help to keep administrative costs down. However, it does lead to a long lead-time in crediting contributions to individual accounts. Second, the lead time needed to set up such a system is considerable, especially with regard to setting up an information technology system; it is important that the administering agency be allowed several years to get a system in place before operations begin. Third, if entry barriers for funds are low, a very large number of fund options are likely to be offered; considerable thought needs to be given to the design and political ramifications of entry barriers. Fourth, engaging new labor market entrants in fund choice is likely to be difficult, and these barriers are likely to be particularly high for some groups—notably those with limited incomes and low English language skills. Fifth, in the absence of entry barriers for funds, a significant percentage of those making an active fund choice may choose funds that are very specialized and risky. Finally, the likelihood of limited active fund choice means that special care must be devoted both to the design of a default fund and to communicating to potential participants what asset allocation and risk-return trade-offs the default fund is likely to make.

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