



RiR 2017:7

## Annual Report of the Swedish Pension System

– clear, sufficient and transparent?

### Summary and recommendations

The Swedish Pensions Agency presents an annual actuarial report on the national pension system, which is called the Orange Report. The report presents and explains the financial position of the national income-based pension. The Pensions Agency also presents future scenarios for the system's long-term development.

The actuarial accounting constitutes an important component of the reformed pension system. The income-based pension system is separate from the central government budget and is estimated to be financially sustainable as long as future pension payments can be funded through both future pension contributions and the financial assets in the system. To ensure that these conditions are fulfilled, the pension system has been equipped with a balancing mechanism, called the brake, which holds back indexation of pension balances and pension payments when the condition is not met. Since the risks in the autonomous pension system are borne by the insured, the presentation in the Orange Report constitutes an important description of how the financial sustainability of the system affects pension levels for current and future pensioners.

The Swedish NAO has audited the Swedish Pensions Agency's reporting of the financial position of the national income-based pension at the close of 2015 and the future

scenarios for the pension system's long-term development. The Swedish NAO considers that the overall presentation in the Orange Report is appropriate and contains valuable information on factors that affect the financial performance of the pension system for the financial year. At the same time, some areas have been identified in which the Swedish NAO considers that the reporting needs improvement.

## **New calculation method for the balance ratio makes new demands on reporting**

The contents of the 2015 Orange Report are affected by several changes in how the system's assets and liabilities are calculated. In order to reduce fluctuation in indexing of pensions, all smoothing of the input components of the balance ratio has now been removed and transferred to a smoothing of the final balance ratio. This is referred to as the "damped balance ratio", which will influence indexation of pensions and pension assets from the turn of the year 2016/2017.

In addition to the new damped balance ratio, the 2015 Orange Report also presents *the system's* balance ratio. The purpose is to measure the financial position of the pension system, and as of the presentation in the 2015 Orange Report, this balance ratio is calculated on the basis of unsmoothed subcomponents. The Swedish NAO considers that the new calculation rules should lead to greater adaptation of the report design. For example, there is no evaluation of how the new calculation method influences the balance ratio as indicator *of the financial position of the system*.

## **Presentation of the system's financial position and underlying factors**

### **The impact of the economy on the financial result of the system**

The state of the economy when the system's assets and liabilities are calculated is of significance for the relationship between the pension system's income and expenditure, since the circumstances in the balance year are used as a basis for calculating the system's total contribution assets. The Swedish NAO wishes to draw attention to the fact that the transition to unsmoothed subcomponents in the *system's balance ratio* makes new demands on the reporting, above all as regards the need for greater focus on the impact of the state of the economy on the system's financial result. The fact is that removal of smoothing of

the subcomponents increases the risk that the state of the economy prevailing in the accounting year will have a stronger influence than previously on the pension system's financial result measured with the balance ratio.

## Reporting of the pension system's key features

In order to give the pension system the best possible distribution policy features in the framework of a financially stable system, the system has been equipped with two features: Indexation of pensions based on average income (income index) and fixed annuity divisors after the time of retirement. The system with fixed annuity divisors means that after the age of 65 there is no revaluation of pensions paid based on changes in average remaining life expectancy after the age of 65. In some circumstances these features create a financial strain on the system. Evaluating these systemic features on a regular basis creates better conditions for analysing whether developments correspond to the intentions of the legislator.

The 2015 Orange Report lacks any calculation of the *net effect* of changes in life expectancy on the system's financial result. There is also no evaluation of the relation between development of the system's assets and liabilities, i.e. the relation between total and average index.

## Reporting of contribution assets development

About 85 per cent of the pension system's total assets consist of the 'contribution asset'. The contribution asset is valued on the basis of the size of pension liability that the pension contributions paid in during the financial year could finance if the conditions prevailing during the accounting year were permanent. The 2015 Orange report does not include comprehensive and transparent analysis of the factors underlying the development of the contribution assets. For example the reporting needs greater adaptation to the new calculation rules for turnover duration, which measures the length of time an average krona of pension contribution remains in the system, thus constituting an asset in the system.

## Analysis of development of the turnover duration

Since 2003 a somewhat downward trend has been observed for the turnover duration. However, there is no deeper analysis in the Orange Report of the development of the subcomponents of the turnover duration and the factors that influence it.

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## **Analysis of risks of imbalances in the pension system**

In connection with reporting the pension system's balance sheet, future scenarios for the long-term development of the pension system are presented. The purpose is to illustrate how different patterns of events may impact the financial position of the pension system and the size of pensions in the long term.

### **Risks concerning unfavourable macroeconomic trends**

The automatic balancing mechanism, combined with actuarial features of the pension system create the conditions for a financially sustainable system. Despite this, some economic and demographic patterns may entail a risk in the long term that the pension system's financial position will be weakened, which will have consequences for the economic standard of pensioners, for example. The Swedish NAO considers that the future scenarios described in the Orange Report do not sufficiently build on an inventory of the demographic and economic risks facing Sweden.

### **Risks concerning the effects of strong variations in macroeconomic patterns**

The financial crisis of 2008 illustrated that the pension system is sensitive to strong variations in macroeconomic patterns. The Swedish Pensions Agency's future scenarios in the 2015 Orange Report are performed statically, i.e. there is no description of how the risk of balancing and the length of the balancing periods, both short and long term, are impacted by realistic cyclical patterns.

### **Reporting of effects for current and future pensioners**

According to both actuarial standards of practice and recommendations from the EU and OECD, a sustainability analysis of a pension system should focus on both the system's ability to finance its long-term commitments and on the pension system's ability to deliver adequate pensions. Comprehensive and transparent reporting of the pension system's individual effects creates the conditions not only for the system's financial sustainability but also its political sustainability.

Since the risks in the autonomous pension system are borne by the insured, the presentation in the Orange Report constitutes an important description of how the financial sustainability of the system affects pension levels for current and future pensioners. The Swedish NAO's assessment is that the documentation presented is not

sufficient to be able to draw any clear conclusions on how future pension levels for different groups of individuals will be affected by the assumptions made in the future scenarios. For example, there is no analysis of how the structure of the pension system impacts financial vulnerability among older people.

One enabling condition for analysing the adequacy of pension benefits is to report all pension benefits, both public and private. However, the pension levels presented in the Orange Report focus solely on the income-related part of the national pension. Neither basic protection in the form of guarantee pension and housing benefits nor group insurance pension are included in the reporting.

Development of basic protection payments is also linked to sustainability of public finances as a whole in the central government budget. If the future pension system cannot deliver adequate pensions then payments of basic protection, i.e. guarantee pension and housing benefits, will increase. This expenditure is charged to expenditure area II, i.e. has a direct impact on the central government budget.

## Application of actuarial standards of practice

The Swedish NAO considers that the Orange Report's general presentation is consistent with the applicable criteria for actuarial accounting. At the same time some parts of the reporting should be strengthened in order to increase its transparency and relevance to decision-makers. The observations presented above are in line with the general recommendations for actuarial accounting prepared by the International Actuarial Association (IAA).

## The Swedish NAO's recommendations

The Swedish NAO recommends that the Swedish Pensions Agency

- strengthens its analysis material regarding the impact of the economy on the system's financial result and the pension system's key features
- further develops analysis of
  - risks of imbalances in the pension system caused by a negative *macroeconomic trend* that reflects economic and demographic challenges faced by Sweden
  - risks linked to *strong variations* in macroeconomic patterns, i.e. an analysis of how severe recessions and other types of macroeconomic shock affect the risk of balancing as well as the length of balancing periods
- develops its analysis of how total disposable income, and thus the relative economic standard for both current and future pensioners is affected by the design of the pension system.

The Swedish NAO recommends that the Government instructs the agency it deems most appropriate to

- assist the Swedish Pensions Agency in further developing risk analysis, i.e. expert support in identification and analysis of demographic and economic challenges faced by the pension system in both the short and long term
- further develop the sustainability analysis in terms of the system's capability to deliver adequate pensions now and in the future.