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Contingency in Risk Management: the Case of Pension Funds in Sweden and Finland

VILLE-PEKKA SORSA & ANTONIOS ROUMPAKIS

INTRODUCTION

One of the key methods for providing understanding on the paradigms of social policy has been to classify different regimes according to their approaches to risk management. Esping-Andersen (1990) famously categorised welfare states according to the levels of decommodification implied by the key institutions providing social protection to the citizens of the states. Within his classification, the Scandinavian welfare states topped the levels and were regarded as 'universalist', providing generous replacement levels on the basis of citizenship. Later, Esping-Andersen (1999) broadened his arguments to broader political-economic foundations of modern welfare regimes, ultimately to the ideal type characteristics of policy-making. Various other scholars have as well combined institutions of policy-making with the institutions resulting from social policies. For example, there have been a great number of explicit critiques on Esping-Andersen's classification supple-

mented with alternative welfare state typologies (e.g. Bonoli, 2001; Castles, 1993; Ferrera, 1996).

The problem with Esping-Andersen's as well as most of the alternative typologies is that although they bring political institutions and thus political contingencies into analysis of social risk management, they tend to ignore the practical aspects of risk management. Most importantly, these kinds of typologies do not usually take into account the social risks that risk management institutions *generate*. Indeed, risk management mechanisms not only respond to and reshape some underlying social risks, but also give new institutional forms to the old risks and create new and sometimes unpredicted forms of social risks. The management mechanisms often transmit the underlying risks to a more general level and may magnify them at this level (e.g. Beck, 1999; De Goede, 2004). This generates not only new kinds of social risks and other contingencies but also new kinds of political situations where risk management issues are addressed. Indeed, risk management is always contingent and not without risks in itself, and it is thus absurd to study the policies and political paradigms underlying the risk management institutions without studying how these institutions are governed and managed.

We believe the issue of contingency must be addressed in any valid theory on politics of social risk management. If we ignore the questions of contingency of the social risks and political contexts created by risk management institutions and the contingency of risk management more generally, both understanding of politics and especially the concrete politicisation of social risk management remain too abstracted. We thus need to bring the real-life operational contexts of risk management to the analysis on the politics of social risk if we wish such analysis to have real-life relevance. The primary purpose of this chapter is to see what kinds of contingencies are included in the risk management institutions tackling the social risks related to old age. Our analysis is focused on pension systems, or pension funds, to be more specific.

Generally speaking, pension funds transform the social risk of failing to generate sufficient incomes for the period of old age into investment and other risks embedded in the funding mechanisms. The funding mechanisms are dependent on the nature of pension schemes at a more general level. For

example, ideal type collective defined benefit scheme (DB) models move individual risks to more collective level, as individual pensions are defined first and costs then adjusted, while the ideal type defined contribution (DC) schemes just changes the risks at the individual level, as pension contributions are fixed and pensions variable. The issue of pension fund governance, including for instance contribution collection, asset allocation and funding level decisions, is central for understanding the contingencies of social risk management wherever funded schemes exist.

Funded, partially funded or prefunded pension systems are not only about alternative forms of arranging pension financing, but also about generating vast pools of capital that can be used in various different ways to achieve different kinds of social and economic policy targets. Pension funds are among the most significant sources of power in the beginning of 21st century (Gourevitch & Shinn, 2005), which is why it is difficult to choose any politically more relevant thematic area for the analysis of social risk management. That said, the academic social policy scholars have had quite limited interest in pension funds and especially investments even though most European countries have recently introduced funding components to their statutory systems. To borrow terminology from accounting, the comparative social policy studies have by and large focused on the 'liability side' (e.g. social functions, pension benefits) of pension provision, while the 'asset side' of pension provision has been somewhat neglected outside pension contribution levels.

Our analysis is in nature a comparative case study, where the focus is on two Nordic countries, Sweden and Finland. To be more specific, we study the institutional differences in the liability and asset 'sides' of funding mechanisms of the funded mandatory earnings-related (first-pillar, second-tier) pension arrangements, the fully funded Swedish AP/PPM funds, and the Finnish partly funded TyEL scheme. The schemes have a massive scope in their welfare effects and share various institutional similarities. The Swedish scheme covers over 90 per cent of all working population, and the Finnish TyEL scheme covers approximately 1.5 million current private sector workers. The countries have been traditionally classified under the same variety of capitalism (mixed but coordinated market economies) and welfare regimes (social democratic, Nordic). In pension policy, the Finnish regime has been

understood to combine some aspects of the Swedish model with continental European paradigms (Hinrichs & Kangas, 2003). However, as our analysis suggests, when we study the contingencies in the both 'sides' of funding institutions, the differences are not that straightforward, and two pension systems are perhaps even more divergent in their social risk management paradigm.

The chapter is structured as follows. In the following section of the chapter, we present a very short overview on the development paths of social risk management in Swedish and Finnish pension regimes from the birth of the regimes to the recent reforms of the last few years from the perspective of social risk management. The birth and development of Finnish and Swedish national pension systems have already been well documented in the academic literature (see e.g. Niemelä et al., 1993; Niemelä, 1994; Salminen, 1987; Kangas, 2006; Kangas et al., 2010; Heclo, 1975; Swenson, 2002; Esping-Andersen & Korpi, 1984; Korpi, 1983; Baldwin, 1990), which is why we do not discuss the issues here at the general level of pension reforms, but focus only on the risk management issues. In the third section, we discuss the contingencies in the current funding mechanisms in these two schemes, first from a general perspective of the funding mechanism and then more closely in both sides of the funding mechanisms, the assets and liabilities. In the fourth and the last section, we draw some conclusions on the Swedish and Finnish cases of risk management from a comparative perspective, and discuss the implications our analysis has concerning the politicisation of social risk management in both countries.

A SHORT HISTORY OF SOCIAL RISK MANAGEMENT IN SWEDISH AND FINNISH PENSION REGIMES

The introduction of the Swedish mandatory earnings-related pension system has been one of the best documented policy reforms in the international social policy literature as it exemplified the power struggle between labour market organisations, Social Democrats and bourgeois parties. This struggle was not only a battle over the issue of redistribution of the pension programme costs and benefits, but also an important struggle over the creation of publicly controlled pension funds. The birth of the Finnish earnings pension regime had

many similarities but also more political and institutional "variables" than the Swedish reforms. The agrarian, bourgeois and fragmented left-wing interests also in fact drew the solutions to a somewhat different organisation of the scheme. Given these backgrounds, the starting point for the era of mandatory pension provision was perhaps surprisingly similar in both countries in context of social risk management.

In broad-brush terms, the initial social risk management paradigm in the two pension regimes can be characterized from the perspective of private sector workers as follows. All (resident) citizens were guaranteed a low universal basic pension with which to cover the risks brought by old age. The first tier of the Swedish first-pillar system (*folkpension*), established in mid-1940s, provided a universal flat-rate benefit for all, as did the corresponding Finnish system (*kansaneläke*) established a decade later. On top of that, workers received a compensation for their loss of ability to work with an earnings-related pension. The Swedish national supplementary earnings-related pension scheme ATP (*Allmän Tilläggspension*) legislation came into effect in 1960 and the corresponding Finnish scheme TEL *(Työntekijäin eläkelaki*) in 1962. Earnings-related schemes in both countries were partly funded and financed by the employer contributions. They provided a defined benefit (DB) scheme that covered extremely high proportion of the working population. The benefits were defined in Sweden by the average salary of fifteen most highly paid years, and in Finland by the final salary. Both schemes also generated assets in a unique scale for partly funded schemes.

There were a few institutional differences in the original form of the two pension regimes. In terms of social risk management, two differences were especially important. Firstly, the two Finnish mandatory first-pillar schemes crowded out nearly all occupational arrangements, which remained strong in Sweden. This suggests that although the *political* importance of the first-pillar regime might have been high in both countries, the *institutional* importance of the first-pillar regime in overall social risk management related to the old-age was much more important in Finland. This difference was further strengthened in Sweden by the ceiling in first-pillar benefits and later in contributions, neither of which have ever existed in Finland. These differences are crucial in political terms, as the Finnish earnings-related regime provides

the primary pension incomes for workers whereas the Swedish regime is only one albeit very significant component among others in the overall pension provision.

Secondly, the assets generated by the earnings-related schemes were organised and invested quite differently. The Swedish assets were decentralised to functionally divided, publicly controlled but somewhat autonomous AP funds. The original three AP funds were for instance not allowed to invest in equity, as employers feared the possibility of so-called 'pension fund socialism' (Overbye, 1996a; 1996b). The three original funds had tripartite boards with different representative weights in different funds. However, the fourth AP fund that was created in the 1970s was controlled by the employees and had a broader mandate to invest in equity and other assets. The investments were mostly made to so-called social investment targets and government bonds.

In the Finnish case, the funds were decentralised to different privately controlled pension providers (pension insurance companies, company funds and industry-wide funds), which had first weak and later strong paritarian control with no public representation (see e.g. Johanson & Sorsa, 2010). The heavily solvency rule constrained investments consisted almost exclusively of so-called premium loans, in which the employers had the legal right to borrow a great part of the contributions (originally in form of paying the contributions in bonds). Put bluntly, the Swedish framework enabled social investments with publicly defined political targets, while the Finnish framework kept capital purely in private hands and in private economic targets.

The risk management created by the regimes concerned the same issues, but in different ways. Both earnings-related schemes reshaped the social risks of old age and brought them to a systemic level. In both cases, some of these risks also materialised. In the Swedish case, the ATP scheme, including the investment targets and in some scale outcomes, was normatively very legitimate throughout its existence. The main risk of the ATP scheme was related to the somewhat fixed contribution rates. In the initial stage, the contribution levels were set quite high in respect to the early benefit levels, and it was broadly assumed that these contribution rates would be sufficient as the scheme matured. Put simply, the risk of old-age income of all Swedish private sector workers was turned deliberately into the systemic risk of having insuf-

ficient contribution rates and investment returns to pay for the DB old-age incomes.

The original levels of pension contributions indeed proved to be too low, and the investment returns were modest. Although both the first and second tier pension programmes showed remarkable institutional resilience, the pension system was considered, due to the severe economic depression of 1990s, not to be able to ever meet its social policy targets in the long run and to have become simply too expensive (see Palme, 2003; 2005; Selén & Ståhlberg, 2007). We will present the scheme adopted in the reforms of 1990s in more detail below.

In the Finnish case, the social policy targets of the TEL (from 2007 TyEL) scheme have been achieved at least this far, and the 'liability side' risks in general have been controlled effectively. However, this has had less to do with the original scheme design than with the constant parametric changes in the scheme (see below). Lately, there have been some accusations that the social partners did not raise contribution rates early enough to keep the anticipated rises in control (there are now greater pressures than ever to raise the rates), but otherwise the scheme, including its governance system, has been considered legitimate. The risks in the original scheme were more related to legitimacy of investments than to pension provision.

Indeed, the TEL scheme was not only supposed to manage the risks of old age, but also to provide private capital for real economic growth (Niemelä, 1994). The risk here was that if the employers did not for some reason need the premium loans anymore, the system design did not enable pension providers to invest in high-risk high-yield targets due to solvency regulations. As Finland opened and liberalised the financial sector in late 1980s, the firms in fact had no more need for premium loans. The recession of the early 1990s made Finnish sovereign bonds a convenient investment target for TEL providers and thus postponed some reforms, but it was clear in mid-1990s that the institution of premium lending and thus the production of economic growth with TEL capital had exhausted – it couldn't answer the policy goals given to it anymore.

Since the initial paradigm, there have been significant institutional changes in both regimes. There have been major institutional albeit not necessarily as

much paradigmatic changes in basic pensions. Both countries have not given up but strengthened universalism in the basic pension system by guaranteeing a basic pension for all over 65 years of age. In Sweden, the whole basic pension system was replaced by a guarantee pension, thus making the earnings-related scheme primary source of pensions. On the other hand, the guarantee pension is subject to the rule of living in total 40 years in Sweden, which has in fact weakened the universalism understood as coverage of the scheme. The Finns continue having a universal basic pension system for all who have lived in Finland for more than three years (albeit lower in benefit levels if the pensioner has lived abroad more than 20 per cent of his time after 16 years of age), which is now also complemented by the guarantee for all those that for some reason fall outside all pension schemes supplementing the basic scheme. The financing arrangements of basic pensions have been changed in both countries. Finland for instance recently abolished the employers' contribution, thus making the scheme fully financed by taxes, and the amount of basic pension received has made subject to the earnings-related benefits received.

Arguably the most significant political changes have taken place in the earnings-related schemes. The Finnish scheme has been developed in parametric style in numerous small reforms concerning the accrual of pensions, indexation rules, and sharing of costs (see Hinrichs & Kangas, 2003). Perhaps most importantly, the scheme has changed from a classic final or average salary DB scheme into a defined accrual scheme, in which rights to benefits are accrued from the salaries as they are paid. The scheme has also been subject to pressures of financialisation in the 'asset side' and governance (see Sorsa, 2011). The investment rules have been changed for many times to improve the ability to invest in higher risk and more profitable investment targets internationally. The regulations concerning pension providers have been homogenised, the investment functions have been made more independent, and the competition between pension insurance companies has been increased. As result, the legitimacy of the scheme has become somewhat more dependent on successes in international portfolio investments in the individual provider level in order to keep costs lower and public opinion positive.

In contrast to parametric changes in the Finnish earnings-related scheme, the changes in the Swedish scheme have been systemic and quite radical in

terms of social risk management. The pension reform that came in effect in 2001 was from the perspective of pension provision a major path departure from the old prefunded DB system to a new partially funded notional defined contribution (NDC) scheme. This change moved much of the bearing of investment and contribution rate risks from collective system levels (state and employers) to individuals, that is, to their pension benefits that are very much dependent on long-term real investment performance. Many demographic components have been added to the pension formulas, and employees now also share costs with employers by paying contributions. The new earnings-related scheme includes on top of the PAYG sponsored income pension a (small) fully funded premium pension (PPM) that is controlled by private asset managers according to employee choice. This suggests that a (small) part of pensions is directly dependent on the financial skills and even pure chance of the employee. The pension provision is no more in public decision-making but only regulated by a government agency.

To sum up, both regimes have somewhat changed in their old age risk management paradigms. Both mandatory and universal two-tier mandatory pension systems originally managed the social risks of old age by transforming the individual risks to collective risks in forms of variable pension contributions and of investment returns. The Swedish regime shifted investment risks from the system level to individuals after the failure to adjust the contribution rates, and eliminated the risk of variable contribution rates to employers with a fixed contribution rate. The institutional changes were broad. The Finnish regime has individualised some risks and changed the nature of collective risks by changing parameters in the pension formulas but without giving up the original risk management paradigm or reforming the institutional arrangement thoroughly. The Swedish case illustrates a very clear change in generating new risks, while changes in the Finnish regime remain more modest. Albeit in different forms in relation to social risk, the proficient operations of both regimes have nevertheless become equally much dependent on the performance of international portfolio investments. Next, we discuss the current form of risk management embedded in the funding mechanisms of these two systems in more detail.

ASSETS AND LIABILITIES: THE FUNDING MECHANISMS

The current funding mechanisms of the Swedish AP funds and Finnish TyEL providers have many similarities. After all, they are both partly and collectively funded schemes that are very much reliant on the PAYG elements. Yet some visible differences remain when we look at some of the key accounting and administration issues of the pension formulas and funding mechanisms. Indeed, these differences are important in terms of understanding the contingency in risk management, both in terms of generation of risks and in terms of formal governance of risk management.

In the Swedish prefunded AP scheme, the logics of accounting follow a notional capitalised pension model. In a pure DC model, the liabilities (that is, the pension benefits) are defined as the workers retire from the overall capital accumulated, the paid contributions with investment yields. In the Swedish AP scheme, however, the capital is accumulated so that the contributions are given a notional interest rate that is dependent on the growth of average earnings (see Barr & Diamond, 2011). In a pure DC model, all the inflowing pension contributions are in principle invested in financial markets. In the Swedish AP system, most of the contributions (around 90 per cent) are directly used to pay the AP pension benefits, while only the contributions exceeding the liabilities (around 10 per cent of contributions) are channelled to investments. The fund assets are thus used only to ensure the liquidity and long-term sustainability of the scheme. The capital is not invested through individual accounts or even within constraints provided by individual liabilities as in DC schemes but via pooled capital. This suggests that the key contingency related to the funding mechanism is how these buffer funds can exist sustainably in the first place – put simply, if they turn negative, there aren't enough contributions to pay for the pensions, and the pensions must be cut.

The accounting logic of the Finnish TyEL scheme can be in part considered inverse to the AP system. In contrast to a prefunded scheme, the TyEL would be better characterised as a permanently under-funded scheme. In simplified terms, if the funds are not sufficient (as they never are) to pay the individual's pension, the (always certain) deficiency can be covered by variable collective contribution rates. The accounting model is not based on capitalisa-

tion as employees retire, but individuals' liabilities are generated (that is, pension rights are accrued) throughout the working career. The accounting of liabilities is individual-based until the employee reaches the age of 54 after which the contributions are pooled. The individual liabilities are again defined and settled between providers when the pension decision is made. The individual liabilities are paid first from the funded component and when this capital runs out, then by a collective PAYG component. Although the pooling technique brings a flavour of buffer funding to the scheme, most of the liabilities are individually accounted in each pension provider, which provides constraints for investment choices through solvency regulations. (Sorsa, 2011.)

Put bluntly, in Sweden the PAYG component is primary and in Finland secondary in the 'marching order' of accounting flows. Although this difference and the more general difference between NDC and defined accrual scheme may seem only technical, they are quite essential in defining the political and the technical *flexibility* of social risk management. It is thus worth elaborating the contingencies in the 'asset side' of the schemes, the investments and contribution rates, and to the 'liability side' of the schemes, the pension benefits, in some more detail.

The asset side: contributions and investments

In case of contributions, there has been a clear choice in the Swedish scheme to fix the rates to a certain level. Basically this means that the costs of this mode of risk management are fixed while the management mechanism itself has to be flexible. From the perspective of employers and employees as contributors, the costs of old-age social risk management are thus fixed and can be anticipated long to the future – it is the benefits and investments that are adjusted if necessary. If the contribution rates were to be changed, it would call for a review of the entire scheme by the so-called Pensions Committee or, ultimately, the government and the parliament. The lack of flexibility within contribution rates also designates less room for policy manoeuvre in the Swedish labour markets, putting pressure solely on AP funds to outperform its targets in order to cover for the too low contributions.

The Finnish scheme has an inverse logic: the risk management mechanism is fixed but its costs are not. The accrued benefits are protected by the constitutionally enforced property right and thus cannot be adjusted but through very specific mechanisms (see below). So, it is the contribution rates that must be adjusted when necessary. Both the employers and the employees pay contributions, the former covering around three and the latter one fourth of the overall contribution rate (at the time of writing 27.2–29 per cent of monthly salary). Formally, the Ministry for Social and Health Affairs sets the contribution rates annually based on legally enforced calculative formulas, which would suggest that the contribution rates vary directly according to the changes in pension payments. In practice, however, the pension providers and the Centre for Pensions first set the bases for the calculative formulas and prepare the calculations before the rates are actually set, which makes the contribution rates somewhat contingent. Furthermore, the pension providers can (and must) use a part of their investment profits to customer compensations for the employer-contributors, which makes a part of the contribution rates even further contingent. That said, the most significant long-term contingency concerning the development of the contribution rates is that all solutions, including the sharing of costs between employers and employees, are ultimately subject to the decision-making by the social partners and other actors in the field (Johanson & Sorsa, 2010).

Although there are adjustment mechanisms for benefits (see below), the long-term investment performance is crucial in defining the financial and social sustainability of the Swedish scheme. Because contributions are fixed, the AP investment activities *must* be flexible in order to optimize investment portfolios to compensate for the possible failures of the funding mechanism in the long run. It is thus hardly a surprise that the investment mandates of the AP funds are based on quite flexible principle-based regulations albeit with a few direct rules concerning the investments. In the AP1–4 funds, all listed and transferable capital market instruments are in principle allowed with the exception of commodity investments.

However, at least 30 per cent of assets must be invested in low-risk fixed income instruments and 10 per cent of assets must be managed by external managers, and there are various allocation ceilings (concerning currency risk,

single security issuers, unlisted securities, Swedish listed company ownership, and more general single entity ownership). Despite these rulings, the sustainability of the AP scheme is very much dependent on the investment performance, and thus the skills of the portfolio managers and the overall international financial market development. When taking the premium pensions into account, the selection of investors of individual accounts further highlights the issue of financial skills as a crucial factor of risk management in the Swedish scheme. The universal application of personal choice over pension fund investment shifts the risks to individuals regardless of their financial literacy, resources available to monitor market volatility or their skills in calculating financial risks.[22]

In the Finnish scheme, the individual providers' mandate to choose investment targets is broad, complemented with various rules and ceilings concerning the investment activities as in the Swedish case. However, the funding mechanism and other regulations further limit the investment activities significantly in various ways, both quantitatively and qualitatively (see Sorsa, 2011, for details). For example of the former, the solvency rules directly control the availability of assets to be invested and the proper overall risk levels of the investments, and make the providers interdependent on each others' choices (in a 'game theoretical' manner). For example of the latter, the usage of mandated external managers (excluding fund investments) is completely forbidden.

Although there are no major obstacles for making investment activities more flexible institutionally, the key issue here is that they don't *need* to be flexible in order to manage the sustainability of the scheme in the long run – it is sufficient to adjust the pension contribution rates that are used to complement the pension payments when the funded assets are not enough to cover the payments. It is, of course, evident that long-term investment performance affects all contribution rates in the TyEL scheme. From the perspective of effectively sustainable social risk management, however, the number one issue is how the contribution rates are adjusted.

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22 *So far the attempt to establish such mass investment culture based on individuals' capacity to manage financial risk has been considered somewhat problematic (see Belfrage & Ryner, 2009; Belfrage in this volume).*

Indeed, the key difference in the flexibility of the asset side of the two schemes is that they give flexibility to different sources of income, which also includes many asymmetries and has important implications concerning the politics of risk management. In Sweden, flexibility is sought by empowering investors, the AP funds, which are made the crucial actors in defining the sustainability of the overall functioning of the scheme, while no flexibility on the contribution rates. This is in contrast to the idea of AP funds as 'buffer funds' – the failure to achieve sufficient investment return *is* a social risk that may lead to the lowering of pension benefits. As the AP funds are directly responsible for the level of pension benefits, it would be wrong to call AP funds merely buffer funds. It must be noted, of course, that the funds are only responsible for the downside risks, not any kind of 'upside risks' – good investment performance does not increase pensions.

While the contribution rates in the Finnish TyEL scheme will change automatically as the pension liabilities increase, the social partners can control the stability of this rise by deciding to 'frontload' expected increases or decreases of costs by agreeing on adjusting the funded amount of contributions. The Finnish scheme empowers social partners, while the investments remain just a matter of lowering the costs of the scheme. In fact, the good investment performance translates only into customer compensations for the employers (which affect employee contributions in the long run as well) while bad investment performance does not, at least directly, imply any changes in contributions.

These differences in the 'politics of the asset side' in the two countries directly shift focus on the governance and accountability of these schemes. Take for example incentives. In case of investments, the Finnish TyEL providers are accountable for positively lowering the pension costs of their customers, while the Swedish AP funds are accountable only negatively for avoiding the cuts in their customers' pensions. In other words, the Finnish scheme structurally provides mostly carrots for developing accountability in investment activities while the Swedish scheme only provides sticks. The Finnish investors have all the reasons to show that they perform well whatever the market situations while the Swedish investors have good reasons to try to shift the blame to financial markets when things go wrong. These are with

no doubt significant differences when we think about the social legitimacy of these schemes. We will return to other governance, legitimacy, and accountability issues in the conclusions section.

The liability side: pension benefits, adjustments and formulas

When it comes to the definition of pension benefits, both schemes share a great variety of contingencies thematically – it is just the mechanisms and their roles that differ. In the Swedish scheme, the pensions accrue from the paid contributions, and the accrued amounts are indexed to the development of average Swedish wage levels. As the pensions are annuitised, the estimation of the pension benefit is calculated based on an annuity divisor with each birth cohort and each retirement age having a specific divisor that directly links pension benefits with life expectancy rates, average ages for men and women recalculated each year. After determining the amount of the pension benefit, this amount is each year calculated based on the annual growth of real wages minus a fixed 1.6 per cent interest rate that supposedly captures the long-term real wage growth. This means for example that if the income index increases by exactly 1.6 percentage points more than inflation, as measured by the Consumer Price Index, pensions will increase at exactly the same rate as inflation. If the increase is lower or higher than 1.6 percentage points, there will be a loss or increase respectively of real income.[23] In order for pensioners to see an increase of their pension, average growth rates should exceed inflation rates and on top of this the fixed 1.6 per cent interest rate.

In the Finnish case, the pensions accrue from salaries variably according to age. For those under 53 years, the accrual rate is 1.5 per cent of the annual wage sum. For those between 53 and 63 years, the rate is 1.9 per cent, and for those between 63 and 68 years, it is 4.5 per cent. The latter, the so-called

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23 The change in the index consists of two parts. The first is the average annual change in average income for the latest three-year period, excluding inflation; the second is inflation for the latest 12-month period ending in June. Pension qualifying income is not known until after the final tax assessment, i.e. in December of the year following the income year. This means that the income for the two most recent years is based on estimates. Errors in estimates are corrected in the indices for subsequent years. (See Pensionsmyndigheten, 2010, for further details.)

'super-accrual', provides strong incentives to have longer working careers. The indexation of accrued pension is arranged so that 80 per cent of the accrued pension is dependent on the overall wage development and 20 per cent on the consumer price index changes. After the initial pension is set, the amount of future pension benefits is adjusted in collective terms in Finland as well. There are at least two key mechanisms in play here. Firstly, the amount of annual pensions is dependent on the consumer price inflation (80 per cent of the change) and the changes in the real wage levels (20 per cent). This reflects the idea that the purchase power of the pension is more important than the changes in for example labour market conditions and productivity growth. Secondly, the annual pensions are dependent on the expected longevity of an age cohort. Currently it seems that the pension benefits will be lower for the future generations than initially expected due to increasing longevity.

Indeed, the two pension schemes have many similarities when looking at the risks related to the *accrual* of sufficient mandatory earnings-related pensions. Looking at the issue from the perspective of risks during individuals' working careers, failing to accrue pension is in both countries dependent on the employment record and wage levels from which pensions are accrued. Looking at the issue from a system-level standpoint, there are again strong similarities in the accrual mechanism. In both countries, the accrual is dependent first on the development in average earnings (albeit less in Finland, in which it is also dependent on consumer price inflation) and, as the pension is annuitised, then on the life expectancy rates of the birth and age cohort. If the average salaries in the Swedish and Finnish economies do not rise but the life expectancy does, it will mean lower accrued pensions for workers in respective countries independent of the working career or salary level track records of these individuals. When looking at the accrual of pensions, there are only two important differences in the two regimes: the Swedish premium pension system makes accrual of pension in part dependent on individuals' financial skills in that regime, and the 'super accrual' incentive makes working in the last years of the working career especially important in Finland.

Some similarities exist between the countries also at the moment of annuitisation of the accrued pensions. The Swedish annuity divisor refers to an adjusted estimate of the expected period of pension-drawing based on the

birth year and the average life expectancy in accordance with the demographic trends and medical advances. The divisor is calculated separately for each age cohort. In Finland, a similar life expectancy adjustment factor is calculated for each age cohort in the age of 62 on the basis of last five years' mortality rates. While the differences in accrual and annuitisation of pensions between the two regimes are significant albeit nuanced, we can find major differences only when we look at the question of how the already accrued (that is, final) pensions are *adjusted ex post facto* over time and how this affects individuals' pensions in real value.

For example, the changes in life the overall real wage development affect the pensions in both countries. In the Finnish case, however, the effects of the development is very limited, as real wages affect only 20 per cent of annual adjustments (80 per cent is defined by consumer prices index). In Sweden, the effects can range from ignorable to ones with utmost importance. The effects of the somewhat arbitrary 'real wages minus 1.6 per cent' indexation rule are quite difficult to anticipate, as it is fully dependent on the development of the relationship between wage levels and inflation.

The Finnish TyEL scheme has no other adjustment mechanisms for the final pensions besides the ones already mentioned, and thus the adjustments of the pension benefits after annuitisation remains rather stable although. The Swedish AP scheme in contrast includes a 'brake mechanism' that automatically balances the relation between assets (the value of future contributions plus the cumulative returns from fund investments) and liabilities (future pension obligations), which is activated whenever the balance between assets and liabilities falls below 1. This is with no doubt the key difference between the two regimes in the 'liability side' of pensions. The Swedish 'brake mechanism' affects benefits according to living expectancy age per birth cohorts, labour market conditions, and even immigration rates (Första AP-Fonden, 2007). The balance mechanism is thus prone to be activated on several accounts.

For example, in the aftermath of the US subprime crisis, in 2008, investment returns averaged -21.3 per cent, and the brake mechanism was activated by removing any indexation in both pension accrual and benefits (Sundén, 2009). However, while financial markets recovered and the profitability of the AP funds was restored, the Swedish labour market still faced lower employ-

ment levels and therefore low overall wage increases in 2009. During 2009 and for the first semester of 2010 there was a substantial change in the actual funding of the schemes since the net inflows from the National Insurance Board (RFV) pension system (i.e. the net of incoming pension contributions minus pension disbursements) was negative. The labour market conditions and the economic recession reduced the funded buffer despite financial recovery, and the pensioners started to expect lower retirement income.[24] It could be argued that employment actually remains the first and foremost influential factor for the financial stability of the balance ratio with net immigration and birth rates mostly boosting the contribution base of the system. Low contributions channelled in the system as well as negative returns from the buffer funds may continue activating the balance mechanism in the future, with contributors and pensioners losing even more through indexation withdrawals.

24 Benefits will be affected in 2011 and 2012. The deficit in the system affects indexation with a lag (see Sundén, 2009).

TABLE 1: Mechanisms potentially causing lower-than-sufficient annual real value earnings-related pensions in the Swedish and Finnish first pillar schemes.

Scheme	SWEDISH AP & PPM		FINNISH TyEL	
Source of risks Location of contingency	Individual	Collective/system	Individual	Collective/ system
Accrual of initial pension (a priori)	Too short employment track record, too low salaries PPM: low investment performance	Decrease in national average earnings	Too short employment track record, failure to benefit 'super accrual' incentives, too low salaries	Fall of national average earnings below consumer price inflation
Annuitisation of the pension		Increase in overall life expectancy		Increase in overall life expectancy
Adjustment of pension benefits (a posteriori)		Decrease in average earnings; activation of the "brake mechanism" (decrease in investment returns, decrease in employment rates, longer life expectancy, lower immigration rates etc.)		Fall of national average earnings radically below consumer price inflation

All in all, the differences between the Swedish and the Finnish earnings-related schemes are summarised in Table 1 in terms of potential negative effects to annual pensions and, to be more specific, of potential causes that can lead to lower-than-sufficient pensions (sufficiency being a political question as such, of course). Perhaps the key difference between the Finnish and the Swedish 'liability side contingencies' is that the annual amount of pensions in Sweden can be very significantly adjusted also with *ex post facto* mecha-

nisms, while the major Finnish adjustments are limited only to the accrual and annuitisation stages. From the perspective of social risk management paradigm, the difference is with no doubt crucial. The Swedish scheme is not necessarily that effective in managing social risks of pensioners, but rather those of employers and workers (see Barr & Diamond, 2011). The Finnish scheme in contrast effectively insures against the social risks of old age, but keeps the division of costs between the employers and the employees an open question.

That said, if we look at the key contingencies in both paradigms more closely, we can see that it is the same social issues that affect the pensions: national employment rates (not just own employment or the success of one's own employer), overall (not just personal) wage levels that define the indexation of accrual and benefits, life expectancy of all citizens (not just workers), birth rates and immigration rates, and all other kinds of issues affecting the basic economic and social conditions of the society. What is easily forgotten here is that automatic adjustments based on these factors are never automatic in the sense that you cannot affect them politically. It just means that the management of the social risks of the old age are made dependent on more system-level issues and, as result, it has been made dependent on more general-level employment, economic, labour market, health, immigration and other national policies. It is not just the risks the individuals face, but also the failures in these policy areas that the pension system as a mode of risk management answers to. In the Swedish case, it is the pensioners who pay the bill for national policy failures unless the funds can compensate for these failures with exceptional investment performance. In Finland, the bill of national failures is not paid by pensioners but the contributors (that is, the operating firms and employees) whose share of the bill can be negotiated. The employers' bill is further dependent on the investment performance of the pension providers.

These issues and linkages may give the governance of these schemes much more political flavour than the issues that seem to be rather technical pension system design issues. For example, the Finnish scheme provides labour unions as well as employer organisations a strong incentive to cooperate in contexts of both national economic policy and of the pension system development in order to avoid rapid growth of pension contributions whatever the reason for the rise (e.g. low employment rates, high wage increases, too low

long-term investment performance). Furthermore, the Finnish pension governance system, which has paritarian elements at every level (see Johanson & Sorsa, 2010), has a strong potential for increasing solidarity between individual firms and employee groups. The Swedish system does not quite provide similar positive incentives. Rather, it provides individual employers an incentive to compete on skilled labour with generous second pillar pension schemes and, as is the case with employees, to question the legitimacy of the rather expensive first pillar scheme whenever pension benefits are cut.

CONCLUSIONS: KEY ISSUES FOR RE-POLITICISING THE PENSION SYSTEMS

The Swedish and Finnish mandatory earnings-related pension schemes we have discussed in this chapter illustrate a great variety of similarities and differences in the contingencies they generate for the risk management. To end the chapter, we discuss some of the key political issues and challenges these differences generate in the respective schemes and countries. The difference between the two schemes can be quite feasibly approached with a few simple questions. Perhaps most importantly, there is the simple question of what can you do if the scheme 'runs out of money', that is, if assets are not enough to meet the liabilities. This is not the only important question, however. One must also ask who is accountable for the performance of the scheme and how, and what kind of incentives you have for improving the sustainability of the risk management paradigm. We will shed light over these questions and highlight some key issues that should be tackled when re-politisizing the schemes in respective countries.

In Finland, running out of assets to meet liabilities is very unlikely to happen due to strict solvency and liquidity controls, and the simple 'balancing mechanism' of pension liabilities reducing whenever employment or wage levels fall. Moreover, if it for some reason is expected to happen, it just implies rather automatic increase in contribution rates for the next year. While the TyEL scheme is considered socially quite legitimate and sustainable (see TELA, 2010), few employers and not that many employees are willing to accept higher pension contribution rates. The increasing contribu-

tion rates have raised some concerns over the justice of generational redistribution, and there have been even some demands for ceilings in contribution rates. These dispositions, and the fact that the scheme delivers primary pensions for nearly all Finns, have lead to constant re-politicisation of individual institutions affecting the costs of the scheme. Given the automatic increase in contributions rates when decisions might be pending, the Finnish solution is politically empowering in the sense that the sustainability of the scheme are matters of contingent decision-making over individual institutions of the scheme, not questions dependent solely on investment returns available from financial markets or on the pension incomes of the masses as in the Swedish case.

That said, it must be noted that the development of the TyEL system is dependent on the *ability* to find consensus or otherwise agree on politicized issues concerning the institutions of the field. As the field of TyEL provision is filled with various administrative, political and institutional tensions (see Johanson & Sorsa, 2010; Sorsa & Johanson, 2011), the overall proficiency of risk management is at a very general level dependent on the agreement between the key actors of the field. In practice, there are no institutionalised bodies that would ensure agreement, but all negotiations are based on ad hoc negotiation group arrangements. Although a first-pillar scheme, even the roles of the government and the parliament have been very limited in the development of the scheme. The role of social partners is in contrast crucial: no change is possible without them agreeing, approving and initiating it. While the Finnish scheme is positively prone to re-politicisation, the actual politics of the scheme are often filled with problems and ambiguities. There is no rigorous political or at least democratic accountability in decision-making. Neither have the main political parties any political incentives to take over the decision-making from the social partners, because it would imply loss of support from employer and employee federations and unions. In case the decisions would decrease pension security, it is convenient for parties to leave decision-making to the social partners.

Lately, there have been major difficulties in finding agreement over the development of the scheme, the main issue on the table being the formal minimum retirement age (currently 63 for old-age pension). One reason for

the difficulties lies in the opposing views of employers and employees. The previous would like to raise the age, while the latter opposes it and highlights the importance of 'super accrual' incentives and of raising the *de facto* retirement age (which is closer to 60) with informal measures and policies. Another reason concerns the groups or committees in which these issues have been discussed. The mandates that the Ministry of Social Affairs and Health has set for the negotiation groups have been all but fit for purpose.

At a more general level, the main political challenge for finding agreement has been the change in collective bargaining cultures. Formerly the pension system development issues were a part of the annual tripartite bargaining over incomes policy (usually called *TUPO*). The potential erosion of the central bargaining may increase 'ad-hoc-ism', and might make it more difficult to get the social partners around the same table with the state, as the partners are already discussing the key issues within the field in various arrangements. The state has, for example, very few concessions in tax policies and economic policy left to lure the employers to ad hoc development efforts. This provides incentives for the government to take direct action, which may distance the parliament from social partners even further. Indeed, while the institutions of the Finnish scheme are constantly prone to re-politicisation, it does not imply that the politics would be democratically accountable, deliberative, or without significant tensions.

If there is something characteristic to the politics of the Swedish AP/PPM scheme, it is the aim at de-politicisation of all individual institutions and variables within the pension scheme. The organisation of the decision-making over the sustainability of the scheme aims at avoiding the re-politicisation of pension governance by placing the system on an 'automatic trail'. The main question with the Swedish scheme is what happens if or when some of the parameters (fewer contributions, low or negative AP funds investment returns, decline of wage growth, increase of inflation rates etc.) remain unfavourable towards the increase of AP/PPM scheme assets. Given that the contribution rates are fixed, the room for policy manoeuvre is all but spacious. It is all about deciding how pensions are cut – about adjusting individual parameters of the brake mechanism, which will cut pensions in any case. Albeit that the AP/PPM is only one scheme among many in providing the overall pen-

sion income, this makes the whole scheme vulnerable to system-level contestation. Indeed, in the AP/PPM scheme, the social risks are not shared and costs redistributed if necessary, but only elevated at the systemic level.

The paradigm of de-politicisation has been present in the governance as well. In the aftermath of the 2008 financial crisis, the Swedish government reformed the so-called Pension Committee, which was originally put together for the creation of AP/PPM scheme, to discuss issues on generosity levels and, essentially, why the AP funds suffered such severe losses during the financial crisis. The Committee is comprised by technical experts, political party representatives[25] and does not include any member from unions or employer associations. Although the government is delegating experts to find solutions (for how to cut pensions if necessary, or how to gain better investment returns), *accountability* is spread among the major political parties and the political system as a whole – it is not directed to experts. For example, the indexation from contribution accruals and pension benefits was removed with the Pension Committee decision to activate the brake mechanism in the aftermaths of the financial crisis, and the government abided. But will this affect the popularity of the government, the whole AP/PPM scheme, or perhaps the AP fund directors? While it is impossible to anticipate the results, it is clear that the government is the only one that can be affected through democratic vote.

The pressure on the sustainability of the AP/PPM scheme lays on the continuation of wage growth and increase of employment levels, but also on the satisfactory returns of the AP funds. As the system is incorporating employment levels and wage growth within the calculation for pension benefits, the employers have no incentives to increase employment levels, as there are no gains in the case of an AP/PPM surplus. Neither is there any indication that the Swedish government would be willing to take an active and intervening role towards the increase of pension assets or shifting the investment principles of AP funds. So it must be asked, would flexibility in the contribution rates be completely unfeasible for employers or politically unacceptable for the employees? While this would with no doubt relieve the negative contingencies of the risk management, it is difficult find political incentives for this

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25 The Left (ex-communist) party opposed the reform and did not participate in the committee.

happening. There is no clear indication why employers would be interested in increasing their contributions towards the AP/PPM scheme in the first place, since they continue to fund second-pillar occupational pensions for their employees, which can be used as a means for competition.

These issues show that in comparison to the Finnish scheme, there are very few incentives for actually developing the sustainability and to control the contingencies of risk management in Sweden – if the system fails, there are no incentives for employers or employees to increase contribution rates. Unless the government changes fundamentally its approach towards the regulation and sustainability of the scheme, a failure to meet a politically and socially acceptable retirement income will be transformed into a systemic questioning of the AP/PPM scheme, and possibly another epic reform of the system.

To end the chapter, it is worth noting that when we combine both the asset and the liability sides of pensions as risk management in the two countries, we can see that they provide different buttons to push in economic policy. Both pension schemes are in nature pro-cyclic, but in a very different manner. When a combined financial and economic downturn hits, the Swedish AP/PPM will react to it by lowering pensions of nearly all Swedish pensioners, while the Finnish TyEL scheme mildly increases the pension contribution rates for all employers and employees (unless otherwise distributed). In Sweden, this means that the effective real demand of the economy falls, which decreases expectations and makes it difficult to find new real investments, and thus ultimately slows down the emergence of any growth prospects. In Finland, it mostly means that at least labour-intensive new productive initiatives and real investments become slightly more expensive, which is hardly a disaster. However, it also gives incentives to cut down jobs, which may lower effective demand and lead to lower pensions in the long run.

Although it is a matter of theoretical economics to evaluate which one is worse, the decrease in effective demand or higher costs of supply, it is clear that the optimal economic policy (both preventive policies and policy responses) is very different in the two countries if we increase our understanding on pensions. This is ultimately what the contingency in risk management is all about in the first place – without understanding these contingencies, it only leads to false understanding on social risks and their politics.

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