



SPEECH

DATE: 25 November 2003
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■ Financial delegation - how do I keep a check on those managing my money?

Introduction

Let me begin by thanking you for the invitation to speak at the Swedish Shareholders Association. During the time at my disposal I intend to discuss the issue of what opportunities we savers have to ensure that our money is not used for purposes other than to improve our personal finances. This is a problem that has dogged us for quite some time and it has risen to the surface once again with the discussions on ownership of certain Swedish life insurance companies. What makes this question particularly interesting for the representative of a central bank are the further complications that can ensue if the general public loses confidence in those managing its savings. If this were to happen, it would affect more than just the savers. There is a risk that we would all be affected in the form of poorer economic growth. As confidence crises can arise in all forms of savings, regardless of whether this is via normal bank accounts, through direct purchases of shares or deposits in funds, I shall discuss the issue on a more general level and not focus on the present problems in the life insurance companies.

Driving forces behind saving

The deregulation of the financial markets that began in Sweden during the 1980s signified major changes for Swedish savers. Suddenly we had much greater rights to decide over our money ourselves and to take many of the savings decisions that were previously a central government monopoly. The rapid and innovative developments in the financial markets also gave savers greater opportunity to choose different types of savings. It is not surprising that during this time we have also seen a large increase in financial savings. The deregulation processes explain some of this. The tax reforms and the return to a low-inflation economy are other explanatory factors. However, the underlying trend is mainly due to demographic changes. As recently as in the 1980s, people invested the greater

part of their savings in real assets, such as housing and durable consumption goods, as well as human capital, i.e. various forms of education. Since then, financial investments, whether in bank accounts or in various types of securities, have taken up a larger part of people's savings. This change can be broadly explained by people adapting their consumption and thereby their savings according to different life phases. When they are young, their consumption usually exceeds their income. This is when people start a family, get an education, buy cars and houses or apartments. To cover all of this expenditure, most of us borrow money. As the years go by, incomes rise, enabling people to reap the fruit of investments in human capital, while they have already made their major investments. Their debts can now begin to be paid off and their financial savings can increase. One conclusion is that the larger the percentage of young people in relation to older people, the larger the savings in real assets. On the other hand, a country with a slightly older population has a relatively large percentage of financial savings. This description applies quite well to Sweden. Bearing in mind the need for change that population developments put onto the pension and welfare systems, it is also reasonable to assume that private financial savings will need to increase further in the near future. This is what will be required in future to be able to manage one's finances after retirement. I discussed the link between this development and inflation in a speech I held on 19 November.

Confidence forms the foundation

When it comes to savings, most of us probably want to diversify as much as possible. Of course, we want to receive a good return on our savings, but at a reasonable risk level. We have also become more aware that it is net return, that is, the return after deductions for various charges, that determines how much our savings are worth. The demand for well-diversified savings at a relatively low cost has created the basis for the substantial expansion in passively-managed share index funds in recent years. Investments in these funds reflect the development of a given index, which means that active management becomes unnecessary. The fact that these funds have been so widely successful, at least on more developed markets, can be seen in the BIS report on institutional asset management presented last spring¹. As the report also shows, developments in the financial markets have opened up more exotic markets and sectors for our savings. Active management is more common on these markets, as the opportunities to pan for gold nuggets that will outperform the market average are considered greater here.

This development has had great significance for the efficiency of the functions supplied by the financial sector. Here I am thinking of the possibilities for risk management and conversion of savings to risk capital for investment. The financial sector also has other important functions, but I will not be discussing

¹ Committee on Global Financial System, BIS, 2003, "Incentive structures in institutional asset management and their implications for financial markets".

■ them today. Diversification, as I mentioned earlier, is one example of how households can simply and relatively cheaply reduce risks in their savings. The increased confidence savers can feel through the diversification offered by various savings companies increases the flow of capital from savers to investors. As national boundaries are less distinct within the financial world, capital is able to move to where it is most useful, whether this is in Sweden or elsewhere in the world.

Deregulation enables market forces to be utilised to a greater extent to allocate capital and manage risks. Once a society has taken this step, it must take the further step of ensuring that individual savers have confidence in the market actors. The possibility for the financial system to supply functions important to the economy in an efficient manner is based on the existence of such confidence. A glance in the rear-view mirror shows that this confidence cannot be taken for granted. What is happening in the life insurance companies now is a good example of this. Although the crisis is fairly limited, it clearly shows how fickle confidence can be. The amount of new savings in life insurance companies has been declining for some time now, but the scandals at Skandia have further fuelled savers' mistrust. According to a survey by Sifo printed in Göteborgs-Posten newspaper on 2 November, three-quarters of the Swedish public lost confidence in life insurance companies after revelations of the scandals.

Herd behaviour causes problems

The risk of confidence problems arising in connection with financial delegation, that is to say, when I put the management of my savings in the hands of someone else, cannot be ignored. This is largely because all forms of financial delegation contain a potential conflict of interests. The person managing my savings may have quite different interest from me.

One example is the herd behaviour observed among asset managers. To some extent, this is a question of rational behaviour based on the assets earning money on the charges paid by savers. It is important to be at least as good as the average to avoid losing the battle for savers' money. Otherwise, it will be much more difficult to attract new savers. From this perspective, the cost of being poorer than average weighs heavier than the gain of being better than average. It will then be rational for asset managers to act in the same way as their counterparts. If everyone else buys IT shares, I as an asset manager will also have to buy them to avoid deviating too much from the rest. The major problem here is that this in turn could have a negative effect on the financial markets. It appears that this is the case. Herd behaviour has been highlighted as one of several possible reasons for the most recent stock market bubble and the ensuing crash.

Large fluctuations in the financial markets make savings less secure. Well-diversified savings, for instance in a fund investing in both shares and debt securities, normally provides good protection against changes in share prices and interest rates, and people are aware of this now. On the other hand, it is less

■ certain that they realise that the asset managers' behaviour in itself can contribute to major fluctuations in the markets, which in turn makes well-diversified savings more risky than they ought to be. If the incentives programmes used to motivate individual asset managers are based on their success in relation to competitors, this can further reinforce negative herd behaviour.

These problems can be aggravated by the construction of the index against which many asset managers are assessed. This is one aspect taken up in the BIS report I mentioned earlier. The weights used to calculate a company's share in many of the most popular indices are based on the company's market value. This tends to lead to overvalued companies being overrepresented in the index. As asset managers' opportunities to deviate from the index by underweighting overvalued companies is often very limited, the unavoidable result is that the manager may be forced to invest in companies that are considered overvalued.

Naïve view of bonus programmes

The remuneration structure for managers of listed companies is another potential source of a conflict of interests affecting savers. Linking senior management's incomes to the development of the share price increases the probability that company management and shareholders will have the same interests. Senior managers will concentrate on increasing the value of the company, as this will give them higher income. The idea is that this will reduce the risk of senior managers occupying themselves with business that will not benefit the development of the company. This also benefits those who have invested their money in a savings company which has in turn invested in the company. The whole idea is, of course, based on the share price also reflecting some form of fundamentally expected change in value in the company.

However, the corporate scandals in recent years show that it was naïve to link the bonus solely to the short-term development of the share price. This evidently gave less scrupulous senior managers an incentive to try to affect the share price through creative accounting or through dubious dealings in an attempt to affect the reported profits. If this type of bonus programme is to function, it will require much more sophisticated systems than merely linking the bonus to temporary changes in the share price. The bonus must be based on actual, sustainable improvements in the company's results and it must have a ceiling. On the other hand, one can wonder why a good salary should not be considered enough incentive to do a good job. Whatever the circumstances, it can be observed that there is tremendous pressure from the general public and authorities to make changes. We should therefore be able to assume that improvements will be made, to reduce the risk of senior managers acting in a way detrimental to shareholders and those saving indirectly in the company's shares.

■ Ownership issue important but difficult

Many people have pointed to the increase in institutional savings as the culprit in the bonus drama. The AP pension funds, the insurance companies and various types of asset management companies have tried to avoid taking on an active ownership role as far as possible. The reason given is that active ownership does not benefit savers. Active ownership costs money and also makes it more difficult to withdraw from a company one is dissatisfied with. The institutions have said they prefer to vote with their feet. If they are dissatisfied with a company, they quite simply sell their holdings in it. One consequence of this reluctance to exercise active ownership has been that more power has been transferred to company managers, who have been able to grant themselves unreasonable fringe benefits.

The emergence of the institutional owner has also led to pronouncements about the advantages of the old, traditional family ownership. Personally, however, I am not entirely convinced that this is the best form of ownership. In Sweden this has meant that one owner has been able to control companies despite a very small capital contribution, what is known as pyramiding. As is the case with excessively powerful company managers, these owners can act in a way that does not benefit other shareholders. In Sweden the desire to control corporate groups has probably often been a more important driving force among some of the traditional owner families than an interest in increasing the worth of the shares.

Personally, I believe that Sweden would benefit from more institutional investors electing to take an interest in ownership issues and how to check on those managing our savings. This would reduce the risk of expressions of avarice such as we have seen in ABB and Skandia. There are also signs that some institutions have begun to think along these lines. For instance, a couple of the AP funds have taken a fairly firm stand on ownership issues. However, it is important that we continue to discuss the role of institutional owners.

A further potential conflict of interests can be found between shareholders and mutual fund participants in the bank-owned investment fund companies. According to Swedish law, an investment fund company shall be a limited liability company and act to maximise the value for shareholders. If shareholders' interests and the interests of those contributing capital do not coincide, there are grounds for a conflict. One example is when a bank-owned investment fund owns shares in a company in which the bank in its turn has an interest as lender. If developments in this company motivate selling shares, and if this in turn could put at risk the capital the bank has lent to the company, there is a risk that the bank would try to influence the investment fund company to retain its shares. On the other hand, this risk should not be exaggerated. In Sweden the protagonists themselves, as well as Finansinspektionen (the Swedish financial advisory authority), have prevented the potential conflict from burgeoning. In addition, there is considerable incentive to act in a way that benefits savers. Bad deals

■ would lead to a risk of savers selling their shares and perhaps most of all to a reduction in new savings.

Dividend ban circumvented

The conflicts of interest we have seen in the mutual life insurance companies are different from those that could arise in the bank-owned investment fund companies. This is because of the special construction of the life insurance companies. The surplus in the mutual insurance companies shall fall to the savers and thus may not be paid out as dividends. Despite this ban on paying out dividends, it is common for mutual life insurance companies to be tied to property and liability insurance companies. One may wonder why. Probably because there are other ways of earning money on savers in life insurance. It is usually the property and liability insurance company that manages the capital of the life insurance company and it certainly does not do this for free. Although Finansinspektionen has the task of examining whether the remuneration paid in these cases is reasonable, there is no regular procurement procedure for the management task and it is difficult to determine whether or not the contract benefits savers. As it is not possible to move their money, savers have no opportunity to take action if they are dissatisfied. The present discussions about Skandia have concerned whether it was right or wrong to sell the management contract to Den norske bank. However, the problem in this case is rather the fundamental contract that gave the property and liability insurance company the task of managing the life insurance company's capital.

It is also common that property and liability insurance companies handle the sales of the life insurance company's insurance policies. This contract was not exposed to competition, either, which means that it is possible that the remuneration to the property and liability insurance company could be lower. There are a number of other examples of how money could have been transferred from the life insurance company to the property and liability insurance company. For instance, one could ask whether Skandia AB's sale of property to Skandia Liv was really made at market prices. Folksam Liv granted loans to its sister property and liability insurance company that had the nature of risk capital. However, the interest on the loans appears to be lower than should be required for risk capital.

The question is how this has been able to happen for so many years, without anyone reacting. We cannot blame it on ignorance of the problems. They have been brought up in various contexts over the years without this triggering any major discussion. Perhaps the current system has become so firmly established in our minds that we have been unable to see the actual risks. This has been the case for me. During the late 1980s I was on the board of directors of Försäkringsinspektionen (the Swedish private insurance supervisory service), but I cannot remember this issue being discussed, despite the fact that the problems were the same then as now. Everyone, from the government and Finansinspektionen to corporate management and consumer organisations, was aware of the problems. Despite this, very little has been done, apart from the introduction of the possibility to establish profit-making companies.

Lock-in effects

I have tried to give examples of conflicts in the savings chain that could have a negative effect on the value of savings. Such conflicts are inherent in all forms of financial delegation and are not, of course, limited to Sweden. The prevailing institutional structures in individual countries can lead to conflicts being expressed in different ways. But the fact that competition for savers' money is not allowed to take full effect is probably an important factor in most cases.

From an international perspective, it is difficult to claim that the supply of savings products in Sweden is too small. On the contrary, Sweden fares well in this type of comparison. Here the problem is rather that competition is curbed by various types of deadlock effects that stem from the old days of regulation in Sweden.

The capital flow to the AP pension funds is safeguarded by legislation. Regardless of what we think of their management, there is little we can do to influence it. Formerly, the AP funds were used for political aims to subsidise house building by allowing them to buy housing bonds and treasury bonds below market rates. Fortunately, this is not the case today. Other parts of our pension savings have gone via collective agreements in the labour market to companies such as Alecta and AMF. We cannot influence the management of the money there either. Some life insurance and pension policies are in turn protected by taxation regulations. The premiums in the "P insurance policies" were made tax deductible in income tax returns, which together with the limited opportunity for transferring money meant that savings were locked in.

There is also a lock-in effect with regard to savings in the investment fund companies attached to the banks. Reluctance to pay capital gains tax when selling mutual fund shares can make savers less willing to sell their shares, despite dissatisfaction with the fund growth. This is of course a problem that also affects those saving directly in equity. These various forms of lock-in effects have curbed competition in the savings market, which together with the obscure ownership in many limited companies, has probably been to the detriment of savers.

A further problem that is of significance to competition concerns financial advice. In the United States there is a whole cadre of independent financial advisers who have no connection to the companies selling various savings products. This is not the case in Sweden. Here we still accept that our investment advice comes from the same people who then earn money on managing our savings. It is self-evident that such a close linking of these roles is far from ideal.

Time for change

So what shall we do? We must ensure that confidence can be maintained in the market participants. There is evidently a need to review the institutional framework regarding the mutual life insurance companies. It is not sufficient to have a general requirement for them to reorganise themselves. The government's decision to appoint a commission to look into these problems is therefore a

■ welcome one. Until this commission puts forward its proposals, it is important to ensure that people who abuse their positions should be replaced. This is precisely what has happened at Skandia. That is good. I think it illustrates that the market economy works. Even if people are upset over events in the life insurance companies, this should not need to entail widespread confidence crises. Some form of prevention can be achieved by pointing out the alternatives for efficiently-functioning, diversified savings offered in the market. Broad index funds with low fees are one example.

It is also important to point out the need for serious financial advice independent of companies selling savings products. There should be a market for this in Sweden, even if it is expensive.

However, releasing the entire potential competition in the savings market is not what would provide the best guarantee that savers' capital will not be used for other purposes than improving savers' finances. If we are to achieve this, the lock-in effects currently hampering competition must be broken. This in turn requires changes in tax regulations and better opportunities for insurance policyholders to move their money. I am aware that these are complicated issues. However, this does not make it any less important to deal with them as quickly as possible.

Thank you.