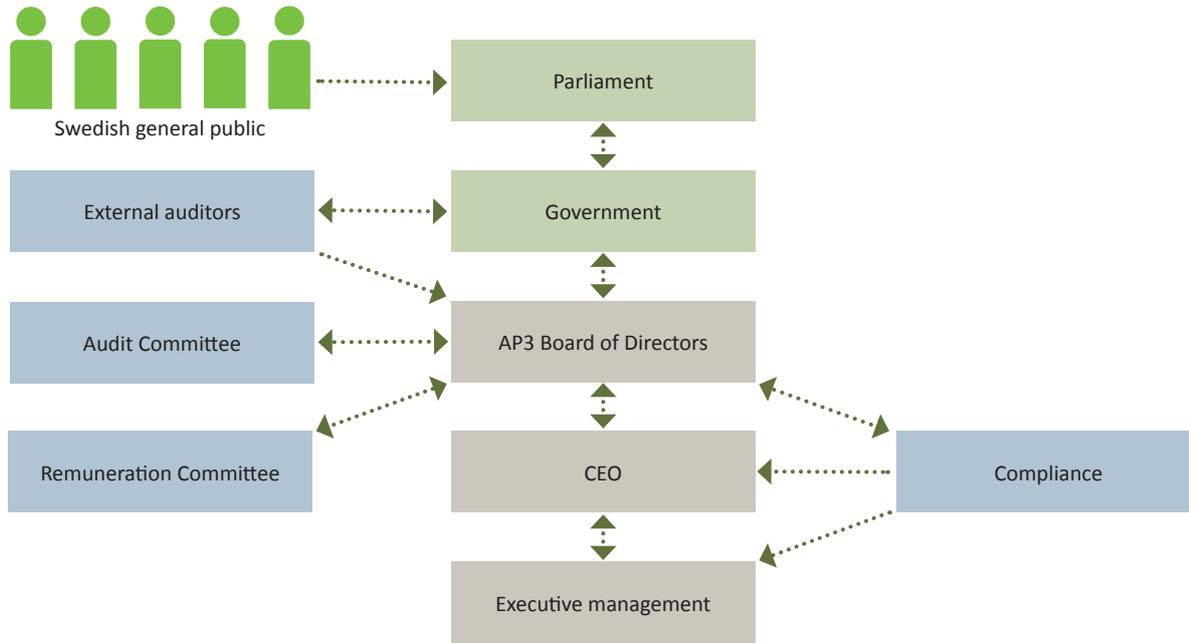


FUND GOVERNANCE REPORT

Governance of AP3



Along with the other AP funds, AP3 is a state-owned pension fund. The AP funds differ from other government bodies in their autonomy from the government. Their operations are almost entirely prescribed by statute and the government has waived its regulatory rights. This governance report was prepared in conformity with the Financial Statements Act and relevant provisions of the Swedish Code of Corporate Governance.

Important external and internal regulations affecting administration of AP3

- National Pension Funds Act
- Financial Statements Act
- Book-keeping Act
- Administrative Procedure Act
- Freedom of information
- Public Procurement Act
- Swedish Code of Corporate Governance
- Policy on Governance and Evaluation of the AP Funds
- Accounting and valuation policies of the AP funds
- AP3's governance framework

Board of Directors

The AP3 Board has nine members, all appointed by the government. Two directors are appointed from nominees of employee organisations and a further two from nominees of employer organisations. The government appoints the Chairman and Deputy Chairman from its own nominees.

The government's "Policy for Governance and Evaluation of the AP Funds" stipulates a maximum eight-year term for directors. In 2012, this rule resulted in Elisabeth Unell replacing Ingela Gardner Sundström as a director. Government policy is for directors to serve one-year terms. Hence, current board memberships extend until approval of the 2012 balance sheet and income statement.

Board administration

The National Pension Funds Act gives the Board of Directors full and collective responsibility for AP3's operations and administration, within the parameters set by Parliament. Board responsibilities and activities not prescribed by statute are set out in the Board's work plan, which is approved annually by the directors.

The National Pension Funds Act also requires the Board to approve an annual operating plan. The operating plan must contain guidelines for investing activities and for exercising AP3's voting rights at the entities in which it invests. It must also contain a risk management plan. Beyond this, the Board's primary tasks are to set operating targets, to recruit and monitor the performance of the CEO, to manage strategic documents and to make decisions on overall Fund strategy, including general risk levels and exposure and risk limits. The directors apply the Fund's dynamic asset allocation model and discuss allocations to the different risk categories and any changes at every Board meeting.

Effective control and monitoring are necessary to ensure that Board decisions are implemented, that risk management is effectual and that the Fund operates in an appropriate manner.

The Board has the task of approving the corporate stewardship policy and managing other stewardship issues such as the Fund's focus areas prior to each AGM season, while generally leaving day-to-day decisions and actions to the CEO.

The CEO and other AP3 employees also attend Board meetings as experts or in a reporting capacity. The Board annually reviews the CEO's administration. The CEO does not attend these discussions.

Review of the Board's administration

The Board of Directors conducts an annual review of its own performance. This review, based in 2012 on a standard questionnaire with space for each director to make personal comments, was dealt with at the December Board meeting.

Remuneration of directors

The government sets the fees and other remuneration payable to directors. Board fees are SEK 100,000 per year for the Chairman, SEK 75,000 for the Deputy Chairman and SEK 50,000 for other directors. These fees have remained unchanged since 2000. The government also has an annual fund of SEK 100,000 to remunerate directors for committee work and other assignments. In 2012 the Board used this fund to pay fees of SEK 26,520 to the chairman of the Audit Committee and SEK 21,220 to other Audit Committee members, and fees of SEK 10,300 to each Remuneration Committee member (including the chairman). See Note 7, Employees, in the 2012 annual report.

Board committees

The Board of Directors has two committees: the Remuneration Committee and the Audit Committee. The Remuneration Committee has the task of ensuring that salaries and other remuneration are market-based, competitive, appropriate and reasonable. It oversees and monitors the implementation of government guidelines, reviews issues relating to the CEO's salary and benefits and approves the salary and benefits of senior executives on the recommendation of the CEO. The Remuneration Committee also prepares the remuneration framework for other employees on behalf of the Board and evaluates the Fund's performance-based remuneration system. The Remuneration Committee reports directly to

Board administration in 2012

The Board held six scheduled meetings during the year and also held an extraordinary meeting to discuss the Fund's formal response to the government report on the buffer funds (SOU 2012:53). One of the scheduled meetings was an extended session to discuss strategic issues and included a visit to the Danish pension fund ATP.

	Board meeting attendance	Remuneration Committee	Audit Committee
Sonat Burman-Olsson	4/7		Member (3/4)
Björn Börjesson, Deputy Chairman	6/7		Member from June 2012 (2/2)
Inga-Lill Carlberg	7/7		
Gunvor Engström	5/7		
Lars Ernsäter	7/7	Member (4/4)	
Ingela Gardner Sundström, up to June 2012	2/2	Member up to June 2012 (1/3)	
Peter Hellberg	6/7	Member from July 2012 (1/1)	Member up to June 2012 (2/2)
Kari Lotsberg	7/7		Chairman (4/4)
Pär Nuder, Chairman	7/7	Chairman (4/4)	
Elisabeth Unell, member from June 2012	4/5		

the Board, which takes the formal decisions. Remuneration Committee members in 2012 were Pär Nuder (chairman), Lars Ernsäter and Peter Hellberg, who replaced Ingela Gardner Sundström in July. The CEO serves as a co-opted member in all issues not relating to her personal remuneration. The Remuneration Committee held four meetings during the year.

The Audit Committee has an advisory and oversight role on the Board's behalf in matters relating to financial reporting and accounting, internal control, risk management and audit. The Audit Committee reports directly to the Board and in 2012 its members were Kari Lotsberg (chairman), Sonat Burman-Olsson and Björn Börjesson, who replaced Peter Hellberg in June. The Audit Committee held four meetings during the year. The Fund's auditors attended meetings held to discuss the final audit and audit management.

Significant issues arising from the Board's administration in 2012

In addition to its task of finalising the annual accounts, budget, operating plan and risk management plan, the Board's work in 2012 included:

■ Allocation decisions

At each Board meeting the directors discuss the Fund's overall risk level as well as individual risk bands for each risk category. Decisions are based on macroeconomic analysis, valuations and investors' appetite for risk.

The Board delegates to the CEO the implementation and management of the portfolio within the allocated risk bands and the CEO reports back to the Board at its next meeting.

Portfolio construction was an important theme in 2012. AP3 seeks to assemble a portfolio with an optimum level of diversification across different risk categories within the parameters of its current investment rules. During the year this ambition resulted in the Board of Directors increasing the allocation of assets to the Other exposure risk category, which groups various diversification strategies. The Board also increased the allocation to real estate assets within the Inflation risk category.

■ Review of the buffer funds

In consultation with its Pensions Group, the government in September 2011 signed a directive to review the regulatory framework of the AP funds. The report (SOU 2012:53) was published in August 2012. The Fund's formal response to the report was a key task for the Board of Directors during the autumn. The response is available in Swedish on the AP3 website.

■ Risk analysis

An understanding of risk and the effective implementation of mechanisms to control them are vital to AP3 in its investment operations. For the last few years AP3 has conducted an annual analysis of total risk that provides a framework for identifying and evaluating risk throughout the Fund's operations. The aim is to identify and measure risk in all parts

of the organisation with a view to taking action where appropriate. Analysis is based on self-assessments conducted internally through the organisation and the results are submitted to the Audit Committee and Board of Directors.

■ Asset management costs

Cost-effectiveness in asset management is always high on the Board's agenda. Costs are also addressed in the government's review of the AP funds and in the official response to this review issued by the Parliamentary Committee on Finance. The Board evaluates costs on a quarterly basis and also receives an annual report from the external benchmarking study produced by Canadian consultants CEM (Cost Effectiveness Measurement), which AP3 has participated in for several years.

Government review

In its review of the AP funds' investment performance in 2001-2011, the government highlighted the fact that the funds had fallen short of their long-term targets. However, the review noted that returns during the period had outperformed the income index, albeit by a slimmer margin than in prior periods due to the weakness seen on equity markets in 2011. The review said the AP funds had continued to develop their strategies and asset management models to achieve greater stability in investment returns and create portfolios capable of coping with market turbulence.

Furthermore, the review noted that AP1, AP2, AP3 and AP4 had continued to strengthen and develop their efforts to promote environmental and social responsibility by integrating these issues in their asset management. The government saw this as a positive move.

External auditors

AP3's auditors are appointed by the government. A government procurement process resulted in Ernst & Young being appointed auditor of the AP funds until approval of the 2013 income statements and balance sheets. The funds' auditors are Jan Birgersson and Peter Strand. Jan Birgersson is also responsible for coordinating the audit process between the AP funds.

Review of administration and financial statements

The auditors' work includes reviewing AP3's operating activities, administration, annual financial statements and accounting records. They express an opinion on the accounting records and the administration based on their audit. Their mandate also includes verifying that AP3 follows the accounting and valuation policies agreed jointly by the AP funds and that the accounting records give a true and fair view of AP3's operating activities.

The auditors report orally to the Board at least once a year and submit written reports on their audit of the annual financial statements and administration. The auditors normally meet the Audit Committee twice a year.

The auditors are responsible for checking to ensure compliance with government regulations on employment terms and conditions for senior managers at the AP funds. The auditors also submit a verbal report to the Ministry of Finance once a year.

Internal control

The National Pension Funds Act (2000:192) tasks the Board of Directors with responsibility for AP3's administration, organisation and overall activities. These responsibilities include ensuring effective internal control. AP3 has a governance framework that defines its administrative systems, risk management and internal control structure. The Board of Directors issues general policies and guidelines that are operationalised through directives from the CEO. All steering documents are revised according to a set timetable.

One key document is the Risk Management Plan, which is approved annually by the Board and defines the division of responsibilities among AP3 staff and departments. The division of responsibilities is designed to support the internal control structure to ensure the autonomy of internal control from the rest of the organisation. This dualistic structure is reflected in access authorisation to AP3's systems.

The internal control function comprises the Middle Office and Compliance departments. Middle Office focuses on financial risk. Compliance handles operating risk and conformity with regulations. Middle Office is in charge of defining, identifying, monitoring and controlling risks arising from asset management operations. It also identifies and reports any deviations from set limits. Limits apply at various levels to ensure that AP3 operates within statutory guidelines and the rules set by the Board and CEO. The Compliance department is in charge of making sure the Fund operates within applicable external guidelines and in conformity with internal policies, guidelines and directives. This includes ensuring that the organisation is aware of relevant rules and applies them throughout its operations. The Compliance department also coordinates AP3's annual review of operating risks and monitors implementation.

Analysis and control is based on transparent daily reporting of positions, risk and financial results. Management reports monthly to the Board (and more frequently if required). Any breach of legal limits or limits set by the Board is reported immediately to the Board. Other incidents, including infringements of internal limits, are reported to the Audit Committee. Significant incidents are to be reported to the Board as soon as they occur.

AP3's Compliance Officer and the Head of Business Support and Control report directly to the Board if necessary.

Internal audit revision

The National Pension Funds Act (2000:192) does not require the AP funds to have an internal audit department. Internal audit has the task of ensuring that controls are implemented. It also verifies and evaluates the effectiveness of internal control. The AP3 Board of Directors asks the Audit Committee to review annually the need for an internal audit and to procure an internal audit if required.

In 2012, PricewaterhouseCoopers (PwC) performed an internal audit of AP3's guidelines and processes for performance review and compliance monitoring of external managers. PwC concluded that the Fund had effective procedures and policies for selecting new suppliers and a strong overview of outsourced operations.

The Audit Committee has decided to assign internal audits to external consultants, and the firm hired KMPG for this purpose in 2012 after a public procurement process.

Legal limits

In 2012 AP3 breached the rule limiting holdings of unlisted assets to no more than 5% of fund capital. This dates back to an imbalance created by a sharp fall in the value of listed assets in 2008 and the fact that unlisted assets did not lose value to the same extent. Since then, the ratio of unlisted assets has remained at just over or just under the 5% threshold, depending on changes in the value of listed and unlisted holdings. At year-end, the ratio was below the legal ceiling and stood at 4.9%. No new investment commitments have been made since 2009.

In 2012 AP3 reduced its holding in Arise Windpower AB to the extent that its share of the voting rights is now lower than the legal maximum of 10% in any one listed entity.