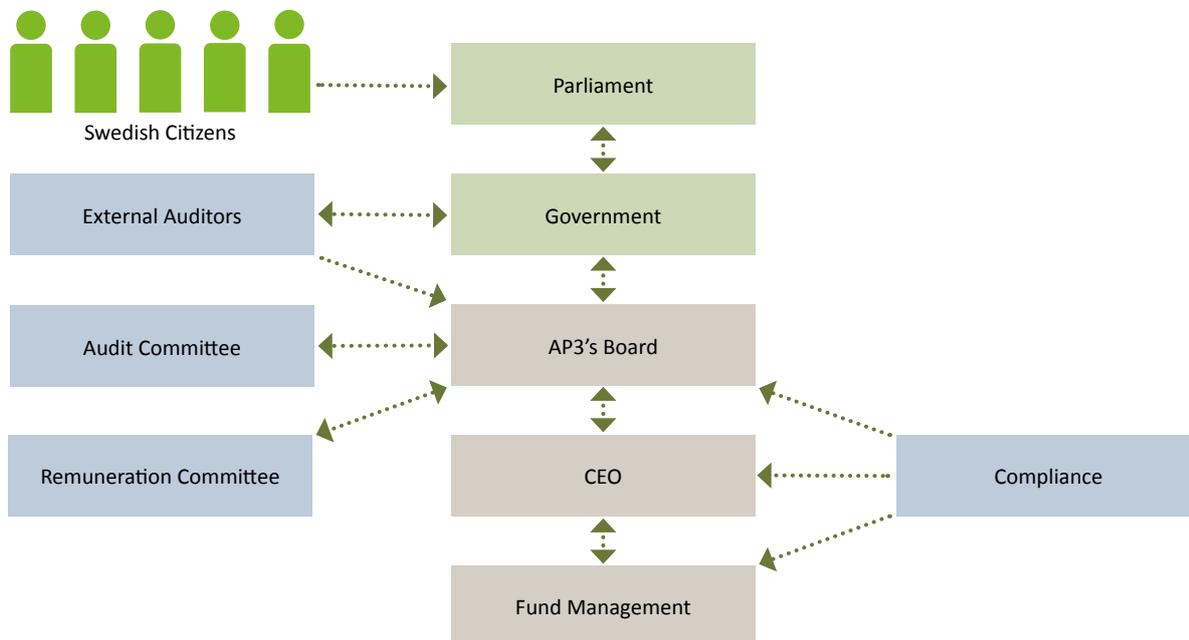


FUND GOVERNANCE REPORT 2013

Governance of AP3



The Swedish Code of Corporate Governance requires Swedish listed companies to publish a governance report. The Code sets best practice standards for companies and organisations active in the Swedish market. This fund 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 rules and frameworks 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

Government agency

AP3 is a state pension fund that differs from other government agencies in its autonomy from central government. The Fund's operations are almost entirely prescribed by statute and the government has disclaimed its regulatory rights. However, AP3 is subject to a variety of internal and external rules and frameworks. The most important of these are presented to the left.

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 that no director may hold board membership for more than eight years. The application of this rule saw Peter Englund replace Kari Lotsberg as a director in 2013. Government policy is for directors to serve 12-month terms. Hence, current board memberships extend until approval of the 2013 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 risk levels, exposure and risk thresholds, budget approval and monitoring, asset management income and resource allocation. At every board meeting the directors apply the Fund's dynamic asset allocation model and discuss allocations to the different risk categories and any changes.

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 structure for control and monitoring is as defined in the risk management plan.

Besides approving the Fund's stewardship policy, which was restructured during the year, the board also handles other policy matters in the field of stewardship including focus areas for corporate AGMs. Day-to-day decisions and actions are left to the CEO, though all decisions to exclude a company from the Fund's investment universe are taken by the board. In 2013 the board excluded four companies from the portfolio.

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. In 2013 this performance review took the form of a questionnaire and personal interviews. The results will be discussed at the February 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 2013 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, in the 2013 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 for senior managers at the AP funds, 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.

In 2013 the Remuneration Committee members were Pär Nuder (chairman), Lars Ernsäter and Peter Hellberg. The CEO serves as a co-opted member in all issues not relating to her personal remuneration. The committee met on two occasions during the year.

Board meetings in 2013

The board held six regular meetings during the year and an additional meeting by remote participation.

	Board meeting attendance	Remuneration committee	Audit committee
Sonat Burman-Olsson	5/7		Member (3/4)
Björn Börjesson, Deputy Chairman	7/7		Chairman from June (4/4)
Inga-Lill Carlberg	6/7		Member from June (2/3)
Gunvor Engström	7/7		
Peter Englund, from June 2013	5/5		
Lars Ernsäter	7/7	Member (2/2)	
Peter Hellberg	6/7	Member (2/2)	
Kari Lotsberg, until May 2013	2/2		Chairman until June (1/1)
Pär Nuder, Chairman	7/7	Chairman (2/2)	
Elisabet Unell	7/7		

The Audit Committee has an advisory and oversight role on behalf of the board in the areas of financial reporting and accounting, internal control, risk management and external audit. The Audit Committee reports directly to the board.

During the first six months of 2013 the Audit Committee members were Kari Lotsberg (chairman), Sonat Burman-Olsson and Björn Börjesson. From 1 July, Björn Börjesson was appointed chairman and Inga-Lill Carlberg joined as a new member in place of Kari Lotsberg. The Audit Committee held four regular meetings during the year. The Fund's auditors attended the meetings held to discuss the final audit and audit management.

Board administration in 2013

The board held six regular meetings during the year. An additional meeting was held by remote participation. One of the regular meetings was an extended session to discuss strategic issues.

In addition to its task of finalising the annual accounts, budget, operating plan and risk management plan, the board's work in 2013 included:

■ Administration

During the year the board reviewed its work plan, committee structure and operations and its instructions to the CEO. As part of its review of the risk management plan, the board also approved a substantial extension of the CEO's delegatory powers. These changes were primarily targeted at more closely aligning governance with the board's and the Fund's approach and organisational structure.

■ Active return targets

During the year the board used an asset liability modelling analysis and a new pension system simulation model to conduct a detailed analysis of the Fund's return targets. The analysis confirmed that the current return target of a 4% real return is appropriate and well balanced. Following the review of Fund targets and investment principles carried out during the year, the board decided this would henceforth be the sole return target that it sets. The CEO will set other return targets.

■ 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' risk appetite. The board delegates to the CEO 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

Work on portfolio construction continued during the year. AP3 aims to put together a portfolio with an optimum level of diversification across different risk categories within the parameters of current investment rules. In this regard, the board in 2013 increased allocation to real estate assets (part of the Fund's 'Inflation' risk category) and added a new investment area – alternative beta – to the 'Other' investment category.

■ Survey of operating risk

An understanding of risk and the effective implementation of mechanisms to control them are vital to AP3 in its investment operations. AP3 annually reviews the Fund's total risk in order to identify and measure risk in all parts of the organisation with a view to taking action where appropriate. This 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 conducted an in-depth cost analysis at its strategy meeting. In addition, the board also commissions an annual external benchmarking study by Canadian consultants Cost Effectiveness Measurement.

Government review for 2012

In its annual review of the AP funds' investment performance, the government noted that all the funds had met their targets for the preceding decade and that returns on the pension system's buffer capital had exceeded the income index since 2001, meaning that the funds have made a positive contribution to the Swedish pension system. The government also emphasised the importance of risk diversification in the asset management process and the need to make long-term evaluations. The government commented that long-term returns had improved since the prior performance review in 2011 and that the AP funds in 2012 had continued to develop methodologies and processes for integrating environmental and social governance in their day-to-day investment analysis and asset management. In addition, the government said it saw scope for improvement in the comparability of the funds' reporting of return and risk.

External auditors

AP3's auditors are appointed by the government. A government procurement process resulted in EY 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 Strandh. Jan Birgersson is also responsible for coordinating the audit process between the AP funds.

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 a minimum of 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.

They 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. In 2013 the auditors had a special focus on integration of environmental and social governance.

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

Internal audit¹ has the task of ensuring that controls are implemented. It also verifies and evaluates the effectiveness of internal control. The AP3 board asks the Audit Committee to review annually the need for an internal audit and to procure one if required.

In 2013, KPMG conducted an analysis of internal and external fraud risks at AP3 and also reported on the Fund's process for valuing OTC derivatives. KPMG concluded that AP3 manages fraud risk effectively in all key respects and that the OTC derivative valuation process was also effective in all the main areas.

Legal limits

AP3 breached no legal limits during the course of 2013.

¹ The National Pension Funds Act (2000:192) does not require the AP funds to have an internal audit function