FSUG Position Paper on the

"Study on the Position of Savers in Private Pension Products"

The Financial Services User Group (FSUG) is an expert group set up by the European Commission following the core objective "to secure high quality expert input to the Commission's financial services initiatives from representatives of financial services users and from individual financial services experts". The mandate of the group is to:

- advise the Commission in the context of the preparation of legislative acts or other policy initiatives affecting users of financial services, including consumers, retail investors and micro-enterprises;
- provide insight, opinion and advice concerning the practical implementation of such policies;
- proactively seek to identify key financial services issues which affect users of financial services;
- where appropriate, and in agreement with the Commission, liaise with and provide information to financial services user representatives and representative bodies at the European Union and national level, as well as to other consultative groups administered by the Commission, such as the European Consumer Consultative Group, the Payment Systems Market Expert Group, the European Securities Markets Expert Group and the Expert Group on Financial Education.

In 2011 the FSUG drafted Terms of Reference for external research to be carried out in the area of the position of savers in private pension schemes and more specifically private pension products, which it identified as a key area of concern. Sustainable provision of adequate retirement income has become a key topic throughout the EU in recent years. In numerous Member States, revisions of public pension funds have been accompanied by the introduction of private pension products, or modifications to existing products. However, recent studies carried out by OECD (2012) question the ability of private pension schemes to deliver adequate and sustainable retirement income under the reasonable risk carried by savers and in a cost-efficient way.
The objective of the study was based on a positive methodological approach aiming to collect and analyze data from a consumer perspective on a wide range of specific metrics in relation to the differing levels of adequacy, safety, risks and cost-effectiveness. European Commission notes that no such overreaching analysis had been conducted to date, and thus the study bridged an obvious gap in the literature.

The study was commissioned to the research company Oxera London (Oxera), which submitted the attached final report. The FSUG worked closely with Oxera, supervised and monitored the progress of the research study. It has engaged in discussions and directed the research company, and it has submitted comments and inputs on a regular basis.

The study covered the private pension systems of 14 EU Member States, which were selected by the FSUG to provide a representative sample of the Member States. The selected countries were: Austria, Estonia, France, Germany, Greece, Hungary, Italy, Netherlands, Poland, Romania, Slovakia, Spain, Sweden and the UK. The study included private pension schemes in respective countries which are defined as both Pillars 2 and Pillar 3 schemes excluding the Pillar 1 (the main source of pension income in most countries) schemes.
The FSUG provided structured series of research questions, on which the study seek to provide information. Research question connected to the ultimate aim of the study were classified into the following topics:
– pension set-up, including information on key characteristics of the systems, most prominent schemes, participation, taxation and other issues;
– charges and costs, focusing on those to be paid by consumers and including analysis of economies of scale;
– returns and risk, which are inter-related;
– information available to consumers, consumer behavior and representation in the pension systems.

Taking into account the predefined positive methodological approach, several important findings drawn by Oxera, which suggest that more attention of policy-makers on national as well as supra-national level is required, can be presented.

1. Pension set-up

At their simplest, pensions are a form of savings where a future pensioner saves now in order to pay for consumption in the future, usually at a point in the life of the saver when they are older than a specified age and no longer employed. However, to persuade individuals to undertake such savings, all countries looked at in the study use either fiscal incentives and/or compulsion to encourage this type of saving, and have created special regulatory and other structures relating specifically to these pension savings. The application of these incentives or requirements means that the resulting pension systems in each country are relatively complex in their nature, and their individual set-up varies significantly between individual countries. This implies relatively complex requirements on savers to understand every aspect of the respective pension set-up and its consequences on its final outcome in a future from the perspective of consumer. This is in a direct contrast with the known low level of financial literacy of most savers participating in a such complex systems.
Understanding the set-up of pensions is important for two reasons:
– the pension set-up is likely to affect 'outcomes' for consumers. For example, in countries with mandatory pension systems and/or strong fiscal incentives, one is more likely to observe a relatively high participation. When assessing 'market outcomes' of pension systems across countries, it is useful to understand to what extent 'positive' or 'negative' outcomes are driven by certain aspects of the pension set-up (which could then potentially be redesigned to improve outcomes for consumers);
– some of the metrics in relation to the pension set-up can be used as part of ongoing monitoring of whether consumers are likely to have adequate retirement income when they retire. For example, if participation is currently low among certain groups or cohorts in a society, or it looks reasonable but contributions are low, this is likely to raise concerns about the adequacy of consumers' retirement income (and policy-makers may want to consider what to do about this now, rather than at the point when these people retire).
There is a considerable quantity of information available on pension system set-ups,

and the data reveals the wide variety that exists among the Member States. However, there are some notable similarities between some of the countries in terms of the set-up of their private pension systems, and it is possible to group the countries into three broadly defined clusters, with two outliers:

– the Netherlands, France, Sweden and the UK, where the private pension systems are oldest and moderately customized for consumers to use. Private pensions tend to be voluntary, but include mandatory components;
– Germany, Austria and Italy, where private pensions were introduced between 1974 and 1993. The level of customization is higher than in the other systems, since they are fully voluntary and include several schemes from which employers and individuals can select;
– the Central and Eastern European countries (Poland, Slovakia, Estonia, Romania, Hungary), with relatively young private pension programmes and strongly emphasized, mandatory occupational plans;
– Spain and Greece are classified as outliers. The Spanish system offers an unusually high level of customization, even including schemes with regional focus; in the case of Greece, the system relies on voluntary joiners and has a low level of take-up.

2. *Charges and costs*

The ultimate performance of a pension scheme, from the viewpoint of the individual saver, depends on the contributions they (and their employer) make to the scheme and the returns that the scheme produces over the lifetime of the savings. For all types of private pension scheme, the net performance strongly depends on the charges applied to the scheme. These charges will in part reflect the cost of providing the pension scheme. Not all costs are directly visible to the consumers (savers), but ultimately one could expect the costs of providing a pension scheme to be borne by the consumer.

Charges can have a large impact on the final value of the pension pot that consumers accumulate during their working life. An annual management charge (AMC) may not initially appear to be that large to individual consumers, but as it is applied to the value of the assets every year, the cumulative impact of the charge increases over time and can be substantial. Therefore, when assessing pensions from a consumer perspective, charges, especially the AMC charges, are an important factor to consider.

Regulators, representatives of consumers and pension providers as well as other commentators have recognized the importance of pension charges, and their relationship with the costs of provision, and there is an increasing demand for analysis in this area. While some studies on charges and costs (and economies of scale) in the literature cover some of the pension systems included in the Study, data on charges and costs has typically been difficult to obtain and has not been readily available on a consistent basis across countries. Reflecting the increasing importance of this topic in the pension's debate, however, the availability of data is improving and can be expected to improve further in the near future, owing to a number of initiatives, including by European authorities.

The study attempted to identify all types of charges and costs, including the costs of trading and post-trading for securities, which are easy to overlook.

Charges also arise owing to the cost of trading and post-trading of securities held by pension schemes. As the cost of trading is not typically included in explicit annual charges, the study presented a framework for assessing whether these charges could be significant in terms of their impact on final pension returns.

3. *Returns and risk*

When a consumer makes a decision about whether to invest in a private pension scheme, they need to consider how much they can realistically expect to receive from the investment in terms of an annual pension upon retirement. For a defined-contribution (DC) pension scheme, this requires decisions about the amount of contributions they will make; assumptions about their likely longevity, the returns of the pension scheme, rates of interest and inflation; and information about the level of charges. For a defined-benefits (DB) pension scheme, in principle there will be a guaranteed retirement income, although depending on the type of scheme the consumer may still hope for benefits in addition to the guaranteed level (typical in Germany, for example), and there can remain a risk that the minimum retirement income is not delivered as defined (which has occurred in a number of different pension systems). If the consumer's expectations for these factors fail to materialize, the pension income will not meet their expectations. The extent of this uncertainty is referred as a 'pension risk'.

In most countries, readily available data on pension fund returns does not go back much more than a decade. Pension funds do assess their returns year on year, as part of normal reporting, but most regulators have not made this information available on a systematic basis, apart from in Eastern Europe (although here the pension schemes are relatively new). Oxera has therefore drawn on alternative sources of information about investment performance over the very long term, available from the wider investment literature. However, historical information can provide only an indication of possible future developments, and robust mechanisms for managing risk will always be required.

Data on relative risk exposure for consumers of different pension schemes is not typically available and there is little quantitative analysis in the literature. Oxera has therefore developed a framework for assessing the relative importance of some of the key risk factors for consumers of DC schemes.

Overall results of the research suggest that there are significant differences in a risk/return profile of private pension schemes even they are subject to the common set-up or management. Even more significant differences can be found among pension schemes in different countries. This implies a strong incentive for policy actions to take a closer look on the forces driving these differences and whether the differences are reasonable.

4. *Saver information, representation and behavior*

Until the recent development of DC-funded pension schemes in Europe, most traditional pension provisioning involved little need for consumers to make decisions. Most retirement income came from state pension systems (pillar 1) and that from the private sector often involved company-run DB schemes based simply on years of employment and final salary. However, the growing role of DC pension schemes has increased the need for consumers to make decisions with regard to both employer-arranged and personal pension schemes:

- employers may still arrange, administer and contribute towards occupational pension schemes, but consumers now tend to have a greater say in investment decisions since they face the investment risk directly; with DC schemes, consumers also need to be more aware of the impact of charges;
- personal pensions are also more likely to require consumers to make investment decisions owing to fewer DB schemes being offered.

Importantly, the number of decisions required from individuals strongly depends on the scheme type. In general, personal DC schemes would give an individual the most choice - in particular, on whether they want to join, how much to contribute and in what assets. This stands in clear contrast to the most restricted schemes, such as the employer-arranged DB contracts, where consumers are often required to join a specific

scheme with no control over their assets or contribution levels, and only an option to opt out.
Are consumers well placed to make these decisions? For consumers to make good decisions, they need access to the right information and sound advice, while their needs should be considered by those controlling the pension system. There is much evidence that suggests that consumers are often not well placed to make good decisions about long-term financial products, and therefore this is an important topic for the wider pension debate in Europe.
Information was drawn primarily from studies conducted into consumer behavior with regard to financial markets, as well as some factual evidence (for instance, regarding saver representation and types of information) collected from national and European pension regulators. Evidence collected from the point of view of the latest thinking from behavioral economics is relatively limited in availability.

FSUG recommendations

Based on the findings of the research, the FSUG makes the following observations and recommendations to the European Commission, other relevant supra-national and national regulators.

A. From its inception, the FSUG has recognized and recommended the importance of having robust measures at European Union level securing high level of private pension schemes´ transparency including the reliable and regularly updated information (data) covering the metrics for adequacy, sustainability, investment risks, returns, charges and other relevant consumer information on private pension schemes set-ups.
Indeed, the Study shows that there is a lack of data availability resulting in low transparency of private pension schemes operations. At the same time, the FSUG observes ongoing divergent development in this area, which requires urgent measures from national and supra-national bodies to revert this trend. More specifically, the following areas do require more attention from regulatory bodies in order to provide more transparency of private pension schemes:

1. Private Pension Schemes NAV: The major problem has been separating the net assets accumulated in plans provided by insurance companies, which are often not reported separately. Apart from that, it has been difficult to find the current asset values for a number of schemes.
2. Private Pension Schemes Portfolio Structures: The data available for personal plans would appear poorer than for the employer-arranged plans. The main issue is the lack of consistency between categories across countries. Standardization of the reporting requirements would help cross-country comparisons and thus increase the ability to compare the overall performance of private pension schemes under the single regulatory regimes.
3. Private Pension Schemes Costs and Charges: The difficulty of finding charge data varies significantly between the investigated countries, from detailed daily publications to quotes from sample providers in the absence of such data. Ideally, the supra-national regulation should ensure, that full spectrum of costs should be available to savers for comparison and analysis, including the otherwise ‘hidden’ costs that result in lower returns, e.g. trading and post-trading. The costs published vary in terms of the granularity. Disclosure of costs on each of the key activities of the pension provider (management, administration, acquisition etc.) would allow for a detailed analysis of

performance and ‘value for money’, from a saver’s perspective.

4. Private Pension Schemes Returns: Typically expressed as average annual growth rates, the main issue about returns data surrounds data availability at the required level of granularity.
5. Private Pension Schemes Savers Behavior (Switching): The information on switching has come in a number of formats; ideally one would report a complete switch matrix detailing both the origin and destination plans, also for cross-scheme transfers. Such detail may be prohibitively complex to collate, but would shed light on the trends beyond simple portfolio re-allocations.

B. Results of the study do not support the proclaimed expectations, that the competition among private pension’s schemes operating under the IORP Directive would bring the level of charges to the market equilibrium levels which would be comparable across schemes within and among the countries. Instead, the study findings show that there are significant differences among the charges, which varies more than 200% in some cases, even within national pension systems. Alarming results can be seen in the performed analysis of final pension pot provided by different pension schemes in particular countries, where the overall charges imposed on scheme members differ more than threefold. These findings open legitimate questions on the adequacy of final pensions and the reasonable level of charges imposed by private pension schemes on their members. Interconnecting the overall poor performance of pension funds with high-level of charges will lead to the overall decrease in the adequacy and thus increase the pressure on already troubled publically run pension schemes and generally on public finance.

C. Considering the dominant risks pension schemes´ members face in most of the DC (or even DB) schemes, the study shows that there is an immediate need to increase the transparency in a form of disclosing the possible negative scenarios and draw-backs caused by particular risks. Current regulatory requirements in most countries do not require providers to disclose any scenarios of future developments that would explain possible consequences of particular risks occurrence nor any calculations of impact of these risks on savers´ final pension pot. The study proved that the ‘known’ information is relatively well supplied, with most schemes providing information during the accumulation phase. But this is in contrast to the provision of the ‘predictive’ data, which is often not supplied by either employer-arranged or personal pension schemes. On top of this, personal schemes tend to provide less predictive information regarding the expected retirement income levels or returns, when compared with employer-arranged schemes.

Regarding the overall transparency of information supplied to the private pension scheme members, several findings can be made:

- there is considerable variation across the individual Member States in the amount of information provided to savers;
- the information tends to be better for fund- than insurance-based products, which presumably reflects the likelihood that fund-based schemes are DC in nature and therefore require consumers to make more decisions (necessitating more information);
- the Netherlands has the best information provision for fund-based products, and relatively poor information availability for insurance-based products;
- the remaining countries (Sweden, Germany, Estonia and Greece) exhibit broadly the same level of information provision.

D. Comparison of advice given to savers confirmed the overall low quality of advice; advisors have not followed all MIFID guidelines when approached by researchers posing as consumers aiming to buy a low-risk investment product. Advisers spent little time assessing their customers and there was concern over due diligence in the recommendations given, although the more developed markets (eg, UK, France) had higher proportions adhering to guidelines. Combining the above mentioned findings and recommendations with the behavior of advisors create the urgent need to standardize the requirements for presentation of information and advisory activities.

E. Another important question when considering a position of an individual consumer in the broader world of private pensions is their level of influence on the shape of the overall pension policy. One of the key mechanisms through which this could happen is when savers are represented at either individual pension providers or the relevant regulatory/supervisory authority. The conclusion, given the current state of research on this topic, is that the Netherlands offers most representation to savers, with a regular, four-yearly election process. There is also a range of schemes in other countries within the employer-arranged category that also admit members on their boards, for instance Pensionkasse and Pensionfonds in Germany (where their participation is optional), or the ITP in Sweden. Interestingly, there appears to be no such representation among the personal schemes in the reviewed countries and overall low level of savers representation in "new" Member States pension schemes, which have been built based on the World Bank, IMF, EC and OECD recommendations and principles.

To summarize the FSUG position, it can be concluded that:

– The study is of overall acceptable quality, but the comprehensive (wider coverage) approach has prevailed. Supplied "database" was meant to be a remedy for the wider approach used for the study, but the proposed methodology required the Oxera to build the database from publicly available data. The data was available for various time-frames available, but only annual basis was used by the Oxera, which decreased the overall quality of the database.
– The study proved significant differences (and divergence) among schemes what is concerning the quality of design, regulation, administration, transparency and asset management.
– The study revealed the un-acceptable differences in charges, costs and overall cost-effectiveness of various pension schemes using the "same" asset management approach.
– The study revealed surprisingly low transparency of "old" schemes comparing to relatively high transparency of "young" World Bank schemes.

In conclusion, the FSUG expresses its overall satisfaction with the presented Study and consider it as an important source of relevant information that can be used by the supra-national and national bodies in their process of increasing the quality of private pension schemes regulatory framework with the "SAVER" in the center of future regulation.