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# Towards a Single Market for European Personal Pensions:

## Building Blocks for an EU legislation



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## 1. Executive Summary

### ***Background***

EFAMA published in September 2013 a report presenting a blueprint for a “European brand” of personal pension products, referred to as “Officially Certified European Retirement Plan” (OCERP). In response to numerous comments received on the name chosen for this product (OCERP), EFAMA has decided to rename it “European Personal Pension” (EPP) to facilitate the public’s understanding of the concept.

The goal of this report is to examine certain aspects of the EFAMA’s proposal which have not been addressed in detail in the report published in 2013. More specifically, EFAMA tries to provide answers to the following questions:

- How will asset managers and other personal pension providers adapt their business models to the creation of an EPP?
- What are the main options for the design of a default investment option? What are the relative merits of life-cycle strategies compared to balanced funds?
- What information should be presented to EU citizens before they start saving in an EPP, as well as during the accumulation and payout phases?
- What distribution and advice rules should be applied to protect EPP holders? Should EPPs be necessarily sold on the basis of independent professional advice?

### ***Key findings***

- The creation of an EPP would help personal pension providers operating on a cross-border basis to centralize some functions, thereby achieving economies of scale, particularly in the areas of investment management and administration. This is the main result of a survey carried out by EFAMA of its corporate members. Our analysis also confirms that the creation of an EPP would open up the possibility for EU citizens to continue saving in the same product when moving from one country to another. This all means that an EU framework for an EPP with common product rules would facilitate capital flows across the EU and enhance cross-border competition in pension provision, thus contributing to a well-functioning Capital Markets Union.
- There is no “one-size-fits-all” default investment option. Default options will always be, to some extent, a “middle of the road” compromise. While life-cycle funds are technically somewhat more complex, they provide the specific advantage of reducing risk when the retirement date gets closer, which makes the retirement capital less volatile close to the end of the accumulation phase. On the other hand, if providing additional retirement income is the goal, a balanced fund that aims at maintaining some higher risk assets throughout the accumulation phase may be seen as a simple and appropriate default option.

## ***Recommendations***

- A single market for personal pensions would be advantageous for both consumers and providers. To maximize these benefits, the framework for EPPs should include product rules to allow providers to offer the same EPP on a cross-border basis. This is a necessary requirement to overcome one of the most important barriers to cross-border activity in the pension market, i.e. the specificities of the national legislation relating to pension products, and to generate economies of scale, particularly in the areas of asset management and product administration.
- An EPP should specify an appropriate investment default option to meet the needs of individuals who are unable or unwilling to choose between different options when saving for retirement. The choice of the optimal default option should be based on Member States' views on the ultimate purpose of a default option. Policy-makers could consider allowing both life-cycle strategies and balanced funds as appropriate default options. The EU framework could also allow Member States to require that one of these two options be offered in their jurisdictions.
- Pre-enrolment communication provisions for potential EPP holders should be standardized and applied uniformly by all providers in a way that facilitate the comparison between EPPs, to help consumers to make the right choice. Further work is needed to develop a synthetic cost indicator and a risk-reward indicator tailored to the specific characteristics of pension products, in particular given the long period of time during which the capital is invested. On-going information should include features such as past performance figures and total ex-post costs. Clear and standardized rules should be adopted to ensure that pension projections offer valuable and transparent information to consumers.
- The level of advice accompanying the sale of EPPs should be calibrated to their level of standardization. There is indeed a trade-off between the protection offered by professional advice and the costs associated with the provision of advice. EFAMA therefore encourages EIOPA to develop an EU framework for a standardized EPP to reduce distribution costs and in this way encourage more consumers to save for retirement.

## ***EFAMA contribution***

EFAMA hopes that this report will contribute to the work undertaken by EIOPA towards the creation of an EU single market for personal pensions. We will engage with EIOPA, the European Commission and other key stakeholders to listen to their comments and questions, and we will continue our work to provide further clarification to all parties involved.

## 2. Introduction

The ageing of the European population and the need to diversify the sources of retirement income have made EU policy makers increasingly attentive to the need to ensure that the internal market functions properly, facilitating the provision of cost-effective and appropriate pension solutions to citizens.

EFAMA fully supports this goal as it believes that the current fragmentation of the EU pensions market is hindering competition, innovation and scale. In such an environment, the choice between different types of pension products and providers remains limited, the portability of pension savings across borders is almost impossible, and the cost of pension products is high.

In July 2012, the European Commission asked EIOPA to provide technical input on the prudential regulations and consumer protection measures needed to develop an EU Single market for personal pensions. In the hope of contributing to this initiative, EFAMA published a report on the so-called “Officially Certified European Retirement Plan” (OCERP) in September 2013.<sup>1</sup> To make it easier for everyone to understand the concept, we have decided to rename it “European Personal Pension” (EPP).

In its 2014 Preliminary Report, EIOPA noted that *“the method proposed by EFAMA, namely creating standards for pension products, would enhance cross-border activity”*.<sup>2</sup> EIOPA’s Chairman, Gabriel Bernardino, confirmed that a single market for personal pensions *“has the potential to maximize scale economies while increasing the level of competition in the marketplace, and delivering high-quality and low-cost pension solutions to beneficiaries”*.<sup>3</sup>

In its very comprehensive report, EIOPA discusses possible building blocks for an EU wide regulatory framework on which to build a single market for personal pensions. EIOPA’s analysis confirms that there are many considerations that will need to be taken into account when preparing such a framework. There are also several key issues for which different solutions could be found. Therefore, it is clear that further work is needed to ensure that the creation of an EPP would indeed be advantageous for consumers, providers, and the broader EU economy.

In July 2014, the Commission released its formal Call to obtain advice from EIOPA in particular on the cross-border, prudential regulation and consumer protection measures required to create an EU-wide framework for personal pensions.

To support the Commission’s initiative, EFAMA has decided to develop further its proposal with a view to providing more information on several aspects which have not been addressed in detail in its 2013 report and contributing further to EIOPA’s work on personal pensions.

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<sup>1</sup> Available here:

[http://www.efama.org/Publications/Public/EFAMA\\_OCERP\\_Report\\_September\\_2013\\_Print\\_Final.pdf](http://www.efama.org/Publications/Public/EFAMA_OCERP_Report_September_2013_Print_Final.pdf)

<sup>2</sup> EIOPA (2014b).

<sup>3</sup> EIOPA (2014a).

We also hope that this report provides a good understanding of why the introduction of a standardized pension product would strengthen the single market for personal pension provision, while also contributing to a well-functioning Capital Markets Union. In particular, we believe the creation of an EU legislative framework for a European Personal Pension (EPP) would particularly contribute to overcome the legal barriers that often prevent capital from flowing between member states.

This report is structured as follows.

Section 3 summarizes the main elements of the OCERP concept developed by EFAMA in its 2013 report.

Section 4 uses the results of a survey of EFAMA's corporate members to explore how EPP providers would adapt their operating model following the creation of an EPP. The section also discusses the extent to which an EPP could be portable across borders, and ends with a summary of the overall benefits that it would bring to EU consumers.

Section 5 seeks to contribute to the discussion on how to design a default investment option as part of an EPP. This question is important because default options play a key role in encouraging pension savings particularly by less financially literate consumers. There is, not only no consensus on how a default option should be designed, but also different views on the optimal investment default strategies, namely between life-cycle strategies and fixed-portfolio strategies. To move the debate forward, EFAMA has decided to examine how these strategies are designed, with a particular focus on life-cycle strategies given the interest shown by both the Commission and EIOPA in this type of solution.

Section 6 explores four areas where further work is needed to attain an adequate level of communication standards to EPP holders: (i) the pre-enrolment communication material; (ii) the calculation and disclosure of pension projections; (iii) information on charges; and (iv) information on past and future performances. This section concludes with a number of considerations on communication requirements for EPPs.

Finally, Section 7 discusses the distribution requirements in the context of EPPs. In its preliminary report to the Commission, EIOPA argues that it is important to consider which advice standards should apply to ensure that the product is the most suitable choice for the potential holders. In this context, EIOPA notes that consumers should only be sold a product with the benefit of independent advice. It recognizes, however, that this argument is less convincing when dealing with standardised products. EFAMA agrees that this issue is important and dedicates this section to its discussion.



### 3. The “European Personal Pension” Concept

The purpose of the September 2013 report was to stimulate a debate on the type of product regulation that could form the basis of the creation of a single market for personal pensions.

Rather than aiming at harmonizing all types of personal pensions across the EU, EFAMA proposed the creation of a new type of personal pension that could be sold across borders, once certified by the competent authority in one member state. Against this background, EFAMA developed a set of standards that a “European Personal Pension” would have to comply with to be authorized for cross-border distribution.

In our proposal, an EPP possesses the following features:

- **Individual membership:** Individuals decide voluntarily to subscribe to an EPP and determine key aspects of their participation, in particular regarding the contribution level, the investment option that best suits their risk profile, and the payout solution at retirement.
- **Individual account:** EPPs are financed by contributions paid to an individual account by EPP holders.
- **Retirement objective:** EPPs are primarily designed to provide an additional source of retirement income, on top of statutory and occupational pensions and other sources of income.
- **Tax treatment:** EPPs should benefit from the tax benefits that are applicable to other personal pension products available at national level.
- **Providers:** EPPs are managed by private financial institutions subject to EU prudential legislation.
- **Funding:** all EPPs are funded.
- **Certification:** The national regulatory body with the power to authorize personal pensions awards the EPP status to those personal pensions that comply with the standards specified in Table 1 below. Once certified in one member state, an EPP benefits from an EU passport and its provider is allowed to market it throughout the EU.
- **Standards:** an EPP should comply with three categories of standards: (i) standards on product regulation, including the product features as well as the pre- and post-enrolment information to EPP holders, (ii) standards on a proper governance framework and administration systems; and (iii) standards on a proper distribution of EPPs at national level and across the EU.

**Table 1: Standards for the EPP**

Standards	Rationale
<b>Investment options</b>	
1. Adequate choice	<ul style="list-style-type: none"> <li>- Meeting individuals' risk profile and circumstances</li> <li>- Facilitating individual choice</li> </ul>
2. Appropriate default option	<ul style="list-style-type: none"> <li>- Helping individuals unwilling/unable to take financial decisions, taking age into account</li> </ul>
3. Clear risk-reward profile	<ul style="list-style-type: none"> <li>- Helping individuals to select an investment option</li> <li>- Providing the basis for categorizing investment options</li> </ul>
4. Ability to switch between options	<ul style="list-style-type: none"> <li>- Offering the flexibility and possibility of switching to a lower risk-reward profile over the lifespan of the EPP</li> </ul>
5. Flexibility in underlying products	<ul style="list-style-type: none"> <li>- Using existing investment vehicles to facilitate economies of scale</li> </ul>
6. Prudent person rule for diversification	<ul style="list-style-type: none"> <li>- Ensuring investor protection</li> <li>- Leaving space for innovation</li> </ul>
7. Ability to offer risk coverage	<ul style="list-style-type: none"> <li>- Reducing individual exposure to investment risk</li> <li>- Offering protection against biometric risks</li> </ul>
8. Access to payout solutions	<ul style="list-style-type: none"> <li>- Linking the accumulation and payout phases</li> <li>- Providing a retirement income solution</li> </ul>
<b>Communication</b>	
9. Clear and consistent pre-enrolment information	<ul style="list-style-type: none"> <li>- Helping individuals make an informed choice</li> <li>- Facilitating comparability between investment options</li> </ul>
10. Accessible annual statements	<ul style="list-style-type: none"> <li>- Providing useful information on a consistent basis</li> <li>- Helping to manage expectations of EPP holders</li> </ul>
11. Full transparency on all costs	<ul style="list-style-type: none"> <li>- Informing EPP holders</li> <li>- Ensuring fair and transparent competition</li> </ul>
<b>Governance</b>	
12. Robust internal and product governance	<ul style="list-style-type: none"> <li>- Clarifying responsibilities</li> <li>- Protecting holders' interests and assets</li> </ul>
<b>Administration</b>	
13. Effective and efficient administration	<ul style="list-style-type: none"> <li>- Maintaining comprehensive record-keeping systems</li> <li>- Offering high-quality services</li> </ul>
<b>Distribution</b>	
14. Consistent regulation of advice	<ul style="list-style-type: none"> <li>- Giving advice in the best interests of the consumer</li> <li>- Applying uniform rules for all personal pension products</li> </ul>
15. Level playing field between different kinds of providers	<ul style="list-style-type: none"> <li>- Fostering competition between providers</li> <li>- Increasing consumer choice</li> </ul>
16. Flexibility of transferability between providers	<ul style="list-style-type: none"> <li>- Allowing individuals to change provider</li> <li>- Encouraging people/job mobility</li> </ul>
17. EU Passport	<ul style="list-style-type: none"> <li>- Creating a single market for personal pension products</li> <li>- Facilitating cross-border distribution</li> </ul>

Source: adapted from "The OCERP: a proposal for a European Personal Pension Product", EFAMA (2013).

As explained above, the goal of this paper is to examine in more detail a number of issues in connection with the standards proposed in our 2013 report.

Standard 2 (appropriate default option) is thoroughly analyzed in section 4. A description is provided on the design of two commonly used default options, i.e., life-cycle and fixed portfolio strategies. Both strategies are compared based on a literature review, and some policy implications are drawn from this analysis.

Standard 8 (access to payout solutions) is also covered in section 4, with a particular focus on the link between the choice of both the investment strategy in the accumulation phase and the payout solution.

Section 5 starts from standard 13 (effective and efficient administration) to focus on the organizational models of EPP providers.

Standards 9, 10 and 11 on communication are further developed in section 6 and standard 14 (consistent regulation of advice) serves as the basis for section 7.



## 4. The Case for an EPP

### 4.1. Introduction

This section is based on the results of a survey that was sent out to the EFAMA corporate members with an expertise in pension policy.<sup>4</sup> The goal of this survey was to include in this report an industry perspective on how the creation of an EPP would change the operating landscape for asset managers.

We start by describing how personal pension providers organise their activity in the current market conditions.

We then address how asset managers would adapt their operating model to the existence of an EPP. Based on the results from the survey, we illustrate how the EPP providers would adapt their business models to maximise efficiency. We develop three scenarios relating to different levels of market integration that could occur with the creation of the EPP.

In the following section we illustrate how an EPP holder could be able to continue accumulating into the same EPP when changing their fiscal residence to another member state.

The final section summarises the positive impact that the creation of an EPP would have for consumers.

### 4.2. The current landscape of the personal pension market in the EU

This section describes the functions linked to the provision of personal pension products (PPPs) and illustrates how their providers operate across borders in the current market environment.

A PPP provider, which may be part of a financial group, sets up its operational structure according to the requirements linked to pension provision and around four key functions (see Chart 1):

- **Investment management:** The investment management function is usually carried out by an asset manager who is responsible for the investment and management of the portfolio of assets.
- **Administration:** The administration function usually deals with the collection of contributions and withdrawals, with the valuation of assets and all the accounting, taxation and communication requirements to consumers.
- **Depository:** Depending on the type of PPP being offered<sup>5</sup>, there can be a custodian that ensures the assets are kept in a secure arrangement or in some cases a depository. Besides

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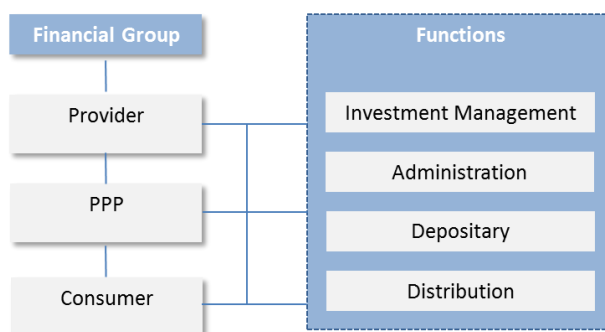
<sup>4</sup> This survey received eighteen responses from EU-based asset management companies.

<sup>5</sup> While under current EU legislation (Directives 2011/61/EU and 2014/91/EU) fund managers are obliged to use safety mechanisms through the mandatory appointment of a depository with custodian and oversight rules, there are other providers which operate under a different model. Insurers, for instance, own the assets by

acting frequently as a custodian, a depositary usually has oversight duties, namely by safeguarding against booking errors and conflicts of interest.

- **Distribution:** PPP providers should have in place arrangements to distribute their pension products to the final consumers, either directly through their linked agents (branches/subsidiaries) or their own internet platforms or indirectly through independent distributors (third-party banks, insurance companies or independent financial advisers). Distributors should provide consumers the information they need to make appropriate saving decisions for their pensions.

**Chart 1: The main functions in the personal pension market**



Currently, each member state has its own legislation for the design of PPPs, the provision of tax incentives, the notification and approval procedures, the marketing and distribution rules and the communication requirements. The specificities of the national legislation explain why the personal pension market is highly fragmented, making personal pension provision a local business. This situation reduces the scope for competition and economies of scale and leads to relatively high prices for the final consumer.

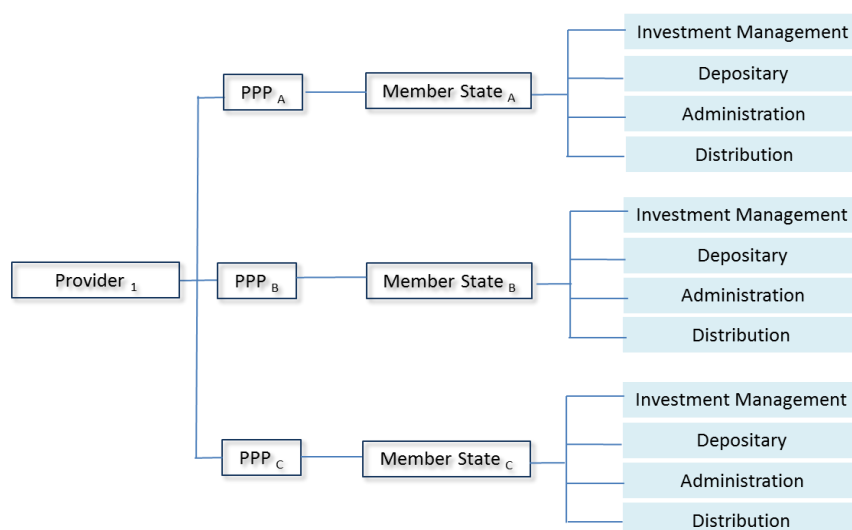
Chart 2 shows how the fragmented personal pension market affects the organizational structure of a provider operating in three different member states. National provisions force most providers to offer three different PPPs and to organise all related services (investment, taxation, accounting, distribution and communication to clients, reporting to the local supervisor) locally in each of the three member states.<sup>6</sup> We call this our “baseline scenario”, which we will use to compare with different scenarios of market integration with the creation of an EPP in section 5.4.

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putting them into their balance sheets and so are subject to capital requirement to protect the final consumer against their insolvency risk,

<sup>6</sup> We recognize that some large financial groups are able to centralise some functions, in particular, in the area of investment management. However, this situation is very much the exception and not the rule.

**Chart 2: The fragmented market for PPP providers operating across borders (“Baseline scenario”)**



### 4.3. Operating models for asset managers

Using the results of the survey, this section explains which functions asset managers would provide in the EPP market and how they would distribute their EPPs in their home member state and abroad. It also sheds light on the approaches asset managers would take to deal with the different tax systems in the EU.

The asset management industry is commonly known for acting as the “manufacturer” of investment solutions, providing its expertise either through investment funds or discretionary mandates to institutional clients such as insurance companies or pension funds.<sup>7</sup> The answers shown in Chart 3 confirm this. All respondents mentioned they would engage in the EPP market as providers of the investment component. One third would act as distributors and one fourth would have an in-house administration function. Overall, 17% of respondents would participate in the EPP business throughout the entire value chain in a so-called business-to-consumer (B2C) architecture, while 61% would act exclusively within a business-to-business model (B2B), by providing their investment expertise to the EPP providers. 17% would act both as provider and distributor and 5% would act both as provider and administrator.

<sup>7</sup> For more information on the asset management industry, please refer to the EFAMA Asset Management Report, which is published on an annual basis. This report provides information and statistics on the business model and clients of the asset management industry. The latest report released on 2014 can be found here: <http://www.efama.org/Publications/Statistics/Asset%20Management%20Report/AssetManagementReport2014.pdf>

**Chart 3: Asset managers' operating model in the EPP market**

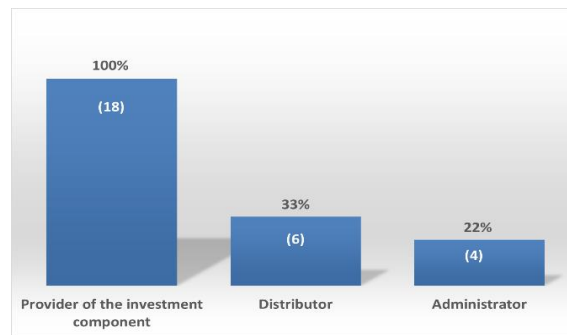
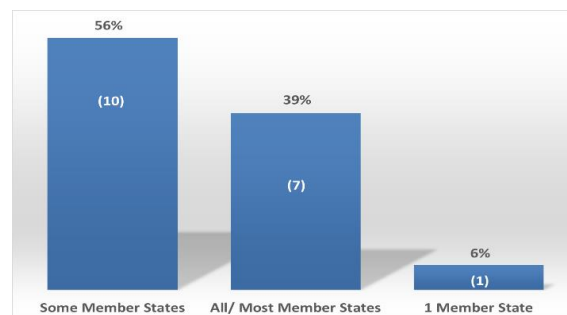


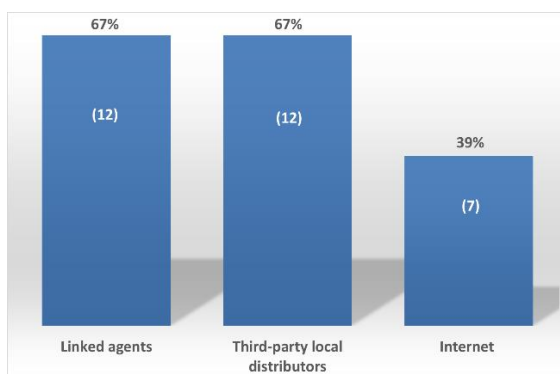
Chart 4 shows that more than half of respondents would use the EPP to target some Member States while one third would use it to broaden their personal pension business to most Member States.

**Chart 4: The target markets of the EPP providers**

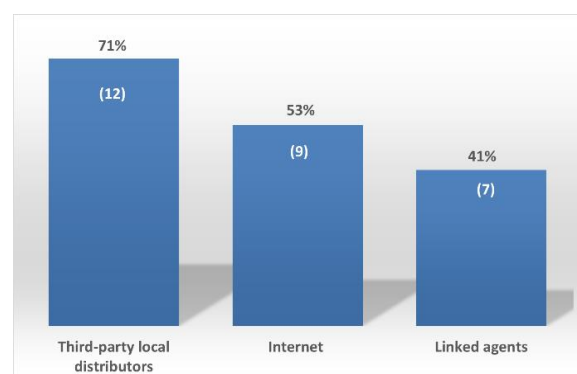


To sell their EPPs in their domestic market, 67 % of asset managers would use linked agents (see Chart 5). The same number of respondents answered they would use third-party local distributors. 39% of respondents would also sell their EPPs through the internet. Overall, 28% of respondents would use all three channels.

**Chart 5: Distribution channels for the EPP in asset managers' domestic market**



**Chart 6: Distribution channels for the EPP in asset managers' cross-border markets**

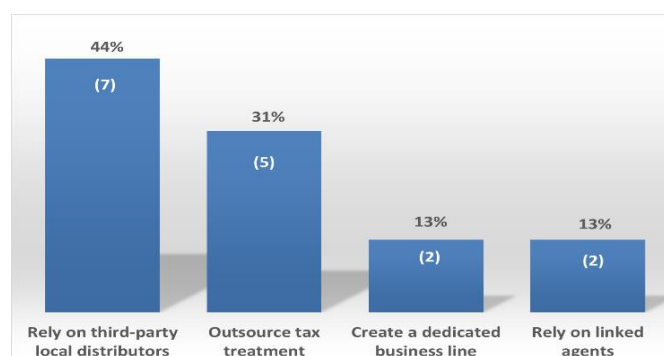


To sell their EPPs across the EU, most respondents would give priority to third-party distributors, 53% of respondents would use the internet and 41% would use linked agents (see Chart 6). Overall, the same proportion of respondents (24%) would use either independent distributors only or independent distributors and the internet. 18% of respondents would use linked and independent distributors.



The different tax regimes in member states are often viewed as an important barrier for the emergence of a single market for personal pensions.<sup>8</sup> The different tax treatment of personal pensions makes not only the cross-border activity of providers more difficult but also the portability of pension savings when people move from one country to another. Chart 7 shows how asset managers would cope with this issue when selling their EPPs cross-border. 44% of respondents would rely on third-party local distributors and 31% would outsource it to a dedicated service provider. The same proportion of respondents (13%) would treat taxation in-house by creating a new business line or would rely on the knowledge and capacity of their linked agents such as branches or subsidiaries locally established.

**Chart 7: How asset managers would deal with different tax regimes when selling the EPP across the EU**



#### 4.4. Scenarios of market integration

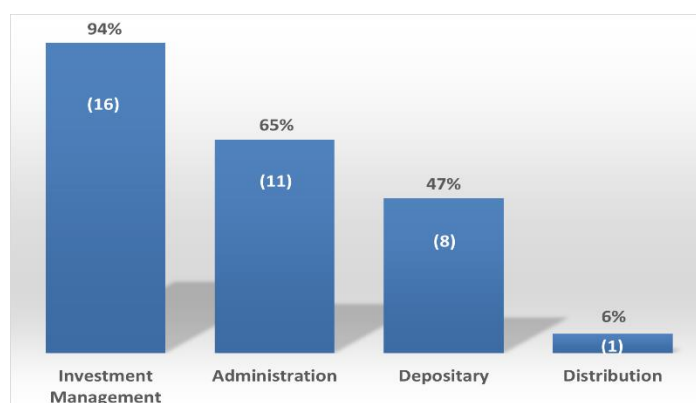
The creation of an EPP would help EPP providers operating across borders to centralize<sup>9</sup> some functions. According to the results of our survey, 94% of respondents would pool and manage the EPP assets at a central level. 65% of respondents would centralise the administration function or outsource it to one service provider. 47% of respondents would centralise the depositary function. In general, asset managers would not centralise the distribution function. This means that, in general, they would distribute their EPPs by using third-party local distributors and/or linked agents, as shown in charts 5 and 6.

Overall, 35% of respondents would centralize the investment, depositary and administration functions together. The same proportion of respondents (24%) would centralize both the investment and the administration function or the investment function only. Those who centralise the investment and depositary also do it for the administration function. Only one respondent would centralise investment and depositary functions only.

<sup>8</sup> In its 2012 White Paper on Pensions, the Commission mentions the risk that cross-border pensions are subject to double taxation. The EIOPA report “Towards an EU single market for personal pensions” analyses the taxation hurdles to the creation of a single market for personal pensions. In its first OCERP report from 2013, EFAMA also acknowledges that the different taxation jurisdictions may make more difficult both cross-border activity of personal pension providers and citizens’ mobility.

<sup>9</sup> By centralization we mean allocating the function to one central department or to one external entity rather than running or outsourcing this function locally in each member state where the provider is selling its EPP.

**Chart 8: Functions that could be centralized in the cross-border activity with the introduction of an EPP**

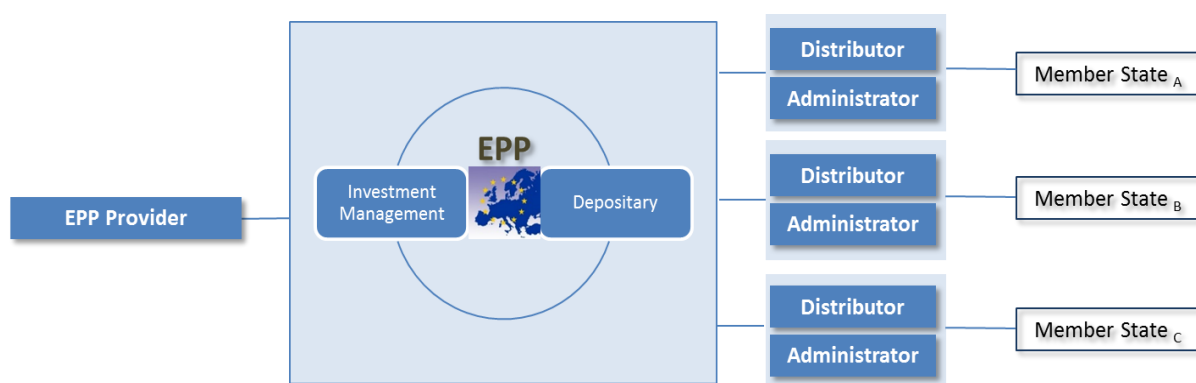


The results of the survey confirm that there can be various degrees of centralization of the functions linked to the EPP provision, depending on the existing operating model of the provider. To illustrate this, we have defined three scenarios of market integration, which can be compared with our baseline scenario presented in Chart 2.

In the first scenario, only the investment management and the depositary functions are centralised (see Chart 9). In this scenario the EPP provider relies on local structures of linked/independent distributors and administrators to support locally its activities in those markets.

The investment and depositary functions could be handled in-house by the EPP provider or be outsourced to a third-party service provider. In the former case, the EPP provider could typically be an asset manager. In the second case, the EPP provider could be an existing personal pension provider which would outsource the investment function to an asset manager and the depositary function to a depositary bank.

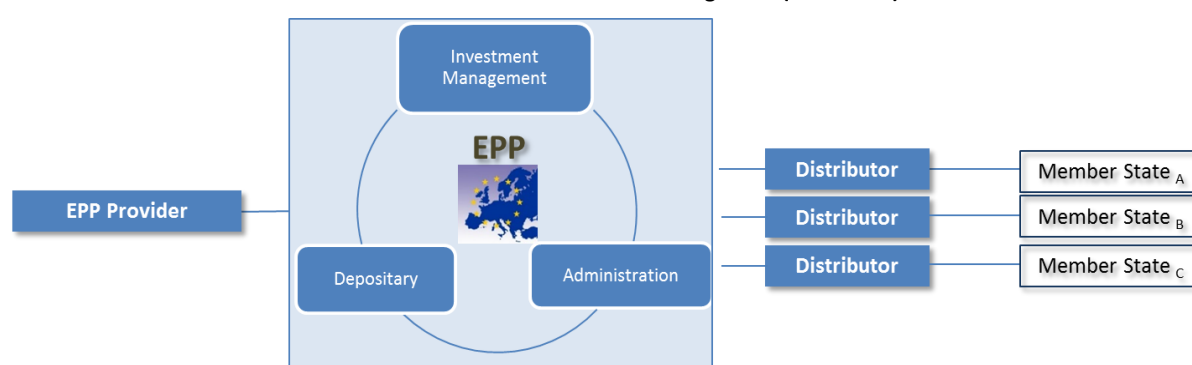
**Chart 9: “Low level” of market integration (Scenario 1)**



In the second scenario, the investment of the contributions from EPP holders living in different member states would be pooled, and the depositary and administration functions would also be centralized (see Chart 10). Our survey shows that 35% of the asset managers who participated in the survey would adopt this business model.

The centralisation of services and expertise foreseen in this scenario would allow the EPP providers to implement a coordinated approach to the management of key operational functions and the oversight of in-house/external service providers. This would facilitate the cross-border activity of EPP providers as they would be able to offer their EPPs in different member states using a more cost-efficient business model. Even if the distribution function is kept local, the EPP provider would benefit from economies of scale thanks to the centralization of the other key operational functions and therefore reduce costs.

**Chart 10: “Medium” level of market integration (Scenario 2)**



The third scenario shown in chart 11 describes the ultimate stage of market integration. All functions would be centralised, allowing an EPP provider to be active in several member states with no local presence or contracts with local service providers. The distribution function, in particular, would be centralised through the use of internet platforms which would be directly accessible to EU consumers. In other words, the provider would sell the same PPP across several markets while managing all related functions from (in-house/outsourced) central hubs. This scenario should not be regarded as unrealistic. The on-going digital revolution has the potential to create valuable on-line tools that would reduce the complexity of cross-border business and the cost of distributing PPPs. This would also reduce the barriers to market entry, thereby enhancing competition.

**Chart 11: “High level” of market integration (Scenario 3)**



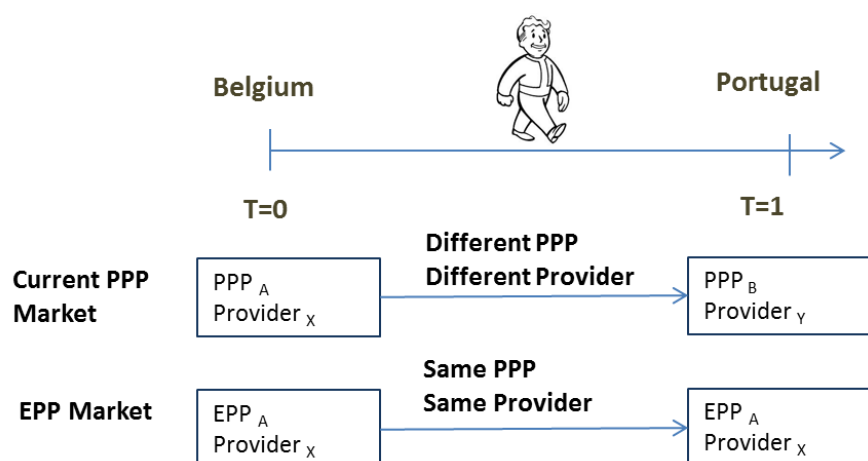
## 4.5. The EPP portability

The different scenarios of the organizational models described in the previous section show that the creation of an EPP would help facilitate the cross-border activity of personal pension providers.

From the point of view of an EU citizen, the creation of an EPP would allow the EPP holders to carry their EPPs from one country to another. Given that the same provider could offer the same EPP in a number of member states, the EPP holder, if moving from one member state to another, would be able to continue making contributions to his/her EPP.

The chart below illustrates the situation of an EU citizen, Alex, who has been saving for retirement into a Belgium PPP and decides to move his residence from Belgium to Portugal.

Chart 12: Two scenarios for Alex when choosing between a domestic PPP or an EPP



At present, in the current PPP market, If Alex would decide to change his residence to Portugal, he would not be able to continue making contributions to his Belgian PPP. His accumulated retirement savings would be locked-in in his Belgian PPP until retirement, and Alex would need to find a Portuguese PPP with a Portuguese provider if he wanted to continue saving for retirement.

It is possible, though, that the provider to whom Alex subscribed to a PPP in Belgium also operates in Portugal. However, in the absence of an EPP, Alex would have to subscribe to a Portuguese PPP and the accumulated capital in his Belgian PPP would be blocked until his retirement.

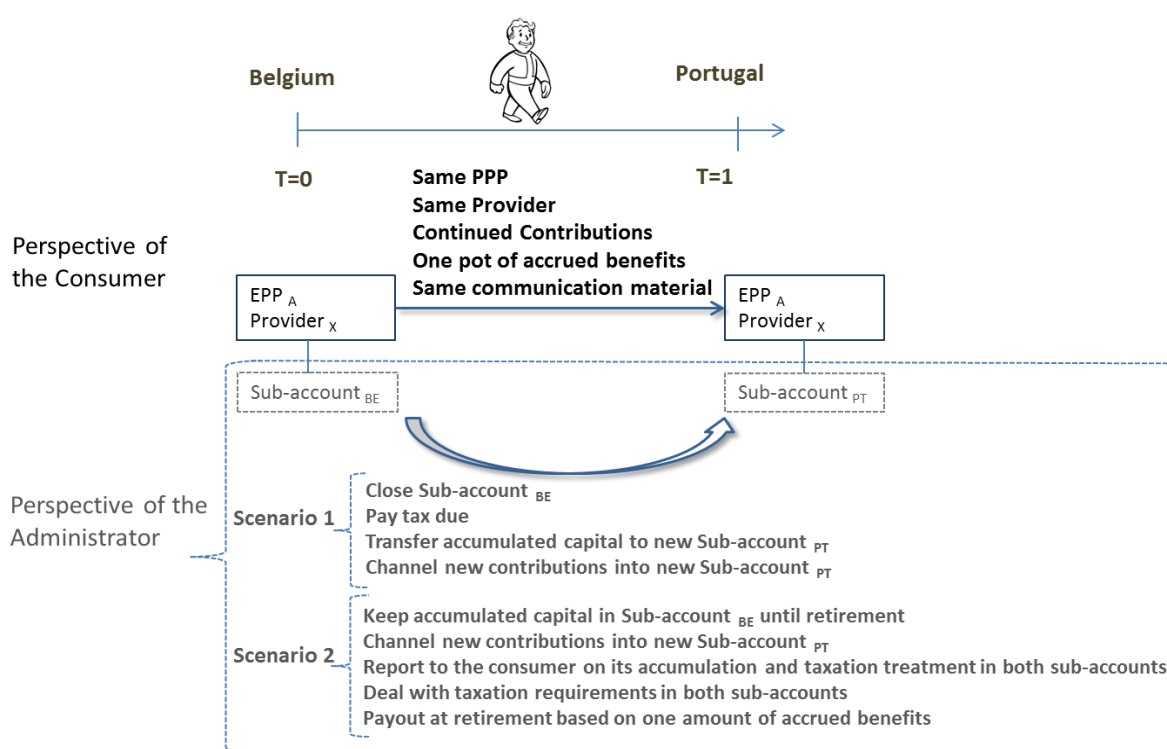
The creation of the EPP would open the possibility for Alex to continue saving in Portugal in the same EPP, if his EPP provider offered an EPP in these two countries, either via an electronic platform, third party distributors, or through a branch or subsidiary.

The chart below illustrates how retirement savings into an EPP would be made simple to a mobile consumer. This simplification would happen thanks to the creation of compartments by the central administration services. In practice, when moving to Portugal, Alex would be making his contributions into the same investment option he chose when he first subscribed to his EPP while living in Belgium.

Everything is kept for him: the same product, the same point of contact, the same communication material. All taxation is dealt with by the central administration services. This can be done either by allocating Alex's savings into two different "sub-accounts" (or in the fund-terminology we used previously, different "share classes") corresponding to Belgium and Portugal and dealing with the on-going taxation requirements from both countries, or by changing Alex's savings from one sub-account to another and closing any taxation liabilities linked to the previous country.

Independently of the sub-account method, the administration services opt for to deal with changes of residence and the consequent differences in tax treatment, Alex will always receive one document with the pension statements and will be contributing into the same investment pot and accumulating one amount that will correspond to his accrued benefits in the payout phase.

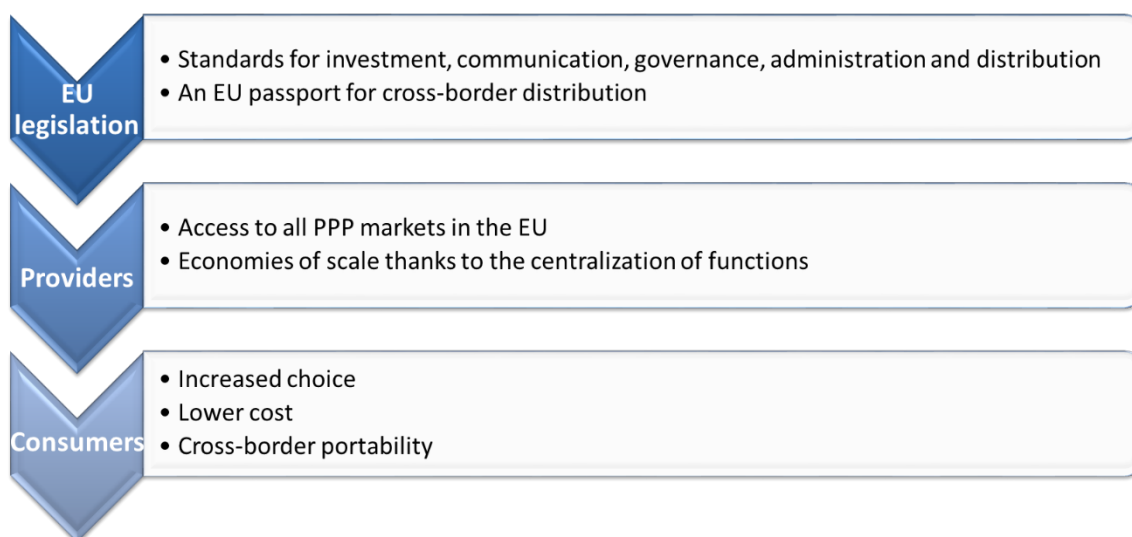
Chart 13: The EPP's Sub-accounts – managing Alex mobility in the back-office



## 4.6. An EPP for the benefit of EU consumers

This section provides an overview of the contribution of an EPP to the single market, by highlighting the benefits to EU providers and consumers.

Chart 14: An EPP for the benefit of consumers



Currently, personal pension providers operate in a market which remains fragmented. Most personal pensions fall outside the scope of any EU prudential legislation and tend to differ across member states. In addition, some member states limit the access of pension provision only to some types of financial institutions and restrict the range of products that can benefit from tax advantages.

The goal of an EU legislative framework for the EPP should be to define standards for the certification of an EPP as a product, the governance and administration arrangements that EPP providers would have to comply with, and for the distribution for EPPs.

The EU legislative framework for the EPP should not aim at harmonising all types of existing personal pensions. Instead, the aim should be to create an EU-wide personal pension product that could be offered to EU citizens, in addition to the products that are currently available at national level.

The creation of an EU legislative framework for the EPP would open domestic markets to all EU regulated financial institutions, and facilitate cross-border activity thanks to the granting of an EU passport that would allow providers to sell the same EPP across the EU. This would allow providers to realise economies of scale, particularly in the areas of investment and administration. There would be also potential to realise efficiency gains in the area of distribution through the use of digital channels.

These developments would benefit EU consumers. Cross-border selling of EPPs would increase competition between personal pension providers, by diversifying the range of product offering and reducing their cost. The broadening up of the boundaries of the personal pension market should also convince leading EPP providers to ensure the cross-border portability of their EPPs, thus facilitating the mobility of EU citizens.

## 5. Design of a Default Option

### 5.1. Introduction

The design of default investment options in defined contribution (DC) pension plans is of critical importance for policy-makers. This has been underlined by many stakeholders, including the International Organisation of Pension Supervisors (IOPS) and the Organisation for Economic Co-operation and Development (OECD).<sup>10</sup> EFAMA has also put a strong accent on this in its 2013 report, stressing, *inter alia*, the need to design a default option in a way that it would meet the requirements of individuals who are unable or unwilling to make an investment choice.

There is an increasing international consensus that some type of life-cycle strategy is desirable for default options, with decreasing risk exposure as the individual ages. However, there are different methods of implementing life-cycle strategies. In addition, it still remains true that in countries where the authorities lay down restrictions on the type of default options, life-cycle strategies are not necessarily the only authorized default investment strategy. For instance, in the USA, both life-cycle funds and balanced funds are defined as legal default options by the Department of Labour.<sup>11</sup>

The on-going debate on the choice of a default investment strategy has convinced EFAMA to explore in further detail the main options for the design of life-cycle strategies and the relative merits of life-cycle strategies compared to balanced funds. Some considerations are also drawn in relation to the link between the investment strategy and the payout solutions. This analysis is followed by some policy implications for the design of an EU-wide default option for an EPP. In doing this, EFAMA hopes to address some of the observations and questions raised by both EIOPA<sup>12</sup> and the Commission<sup>13</sup> on the use of a life-cycle strategy as a possible default investment option for an EPP.

### 5.2. Design of life-cycle strategies

In its Preliminary report to the Commission, EIOPA defines life-cycling as

*“a type of default investment option whereby the investment decision is determined by the stage of the life-cycle that the pension contract has reached. In the early stages of the pension lifetime the investment will be in somewhat riskier products designed to achieve capital growth. As the contract nears its final stages, i.e., when the pension holder is close to retirement, the investment strategy will switch to a more conservative approach designed to consolidate the capital growth already achieved and avoid market volatility. In reality, this life cycling move to less risky investments is usually a gradual*

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<sup>10</sup> OECD (2010) and IOPS (2012).

<sup>11</sup> See “Regulation Relating To Qualified Default Investment Alternatives In Participant-Directed Individual Account Plans”. More information on can be found here: <http://www.dol.gov/ebsa/newsroom/fsQDIA.html>.

<sup>12</sup> EIOPA (2014b: 60).

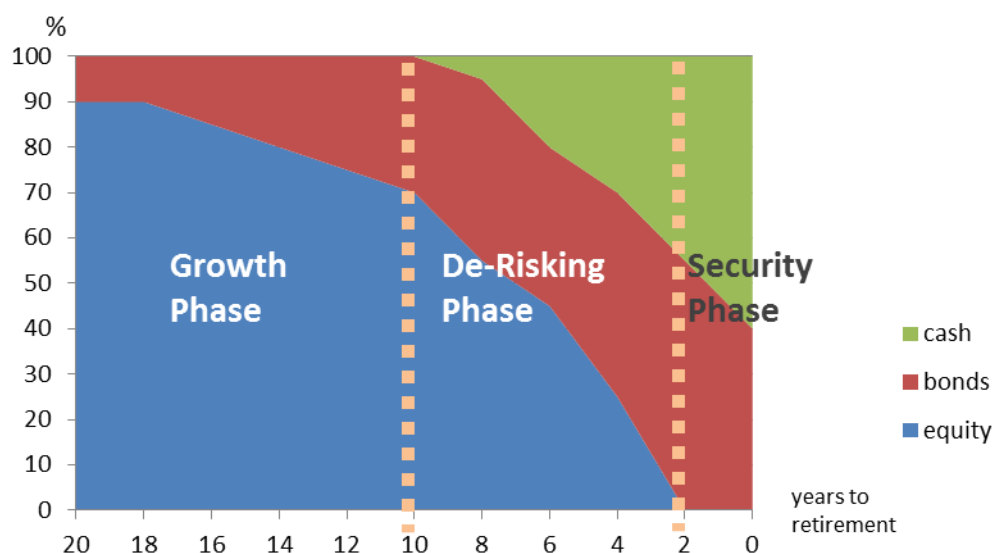
<sup>13</sup> The Commission (2014: 15) adds that it is possible to introduce a basic investment product following the life cycling concept, since it offers more flexibility in investment options over time.

process with incremental change over a number of years leading up to the end of the accumulation phase.”<sup>14</sup>

This description sums up the very essence of life-cycling. Indeed, the underlying premise of all life-cycle strategies is to gradually reduce portfolio risk throughout the investment period, typically by reducing the equity exposure in favour of fixed income and cash as consumers approach retirement. The asset allocation schedule that becomes more conservative over time is frequently called “glide path”.

The graph below illustrates the main phases that characterise a typical life-cycle strategy: the *growth phase* when the investments are made in a mix of “growth assets” (equity) and “conservative assets” (bonds and cash), the gradual *de-risking phase* when the share of “growth assets” is gradually reduced, and the *security phase* close to the retirement date, when the accumulated capital is locked-in mostly in “conservative assets” to avoid any potential losses.

**Chart 15: Illustration of the typical phases of a life-cycle strategy**



Generally, life-cycle strategies can be achieved by using a mix of different investment funds and adjusting the asset allocation between funds over time or by relying on a single fund. In the former case, the consumer will typically hold units in several funds at any point in time, whereas in the latter case, s/he will hold units in one fund. These arrangements are explained in further detail below.

### 5.2.1. Life-cycle strategies using a mix of funds

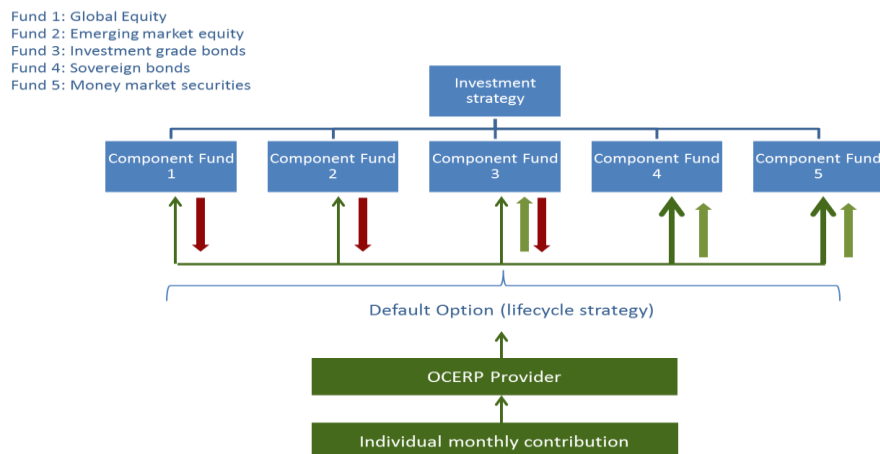
Life-cycle strategies using a mix of funds adjust their asset allocation by varying the percentage weightings of the selected funds according to the holder’s planned retirement year. The allocation between the different funds changes over time, according to a glide path that gradually reduces risk by changing the percentage weightings, from the most risky funds to the most conservative ones, until the holder’s planned retirement year.

<sup>14</sup> EIOPA (2014a: 93).



Chart 16 below illustrates a life-cycle strategy based on the use of “pure funds”, i.e., equity funds, bond funds and money market funds. Providers can also rely on balanced funds to obtain a glide path that gradually reduces risk. Typically, when a consumer chooses a life-cycle strategy that builds its glide path using a mix of funds, s/he will be holding units in the funds being used during the accumulation phase.

**Chart 16: Life cycling using a mix of ‘pure’ funds**



### 5.2.2. Life-cycle strategies using a single fund

Life-cycle strategies using a single fund may either adjust the asset allocation by moving from one fund to another during the accumulation phase or by using one fund whose glide path is built through investments in other funds and/or assets. In both cases the consumer is only holding units in one fund (at a time, in the first case) throughout the accumulation phase.

**Chart 17: Life cycling strategy using balanced funds**

Fund 1: *aggressive* – 90% equities / 10% fixed income  
Fund 2: *moderate* – 50% equities / 50% fixed income  
Fund 3: *conservative* – 90% fixed income / 10% equities  
Fund 4: 100 % money market

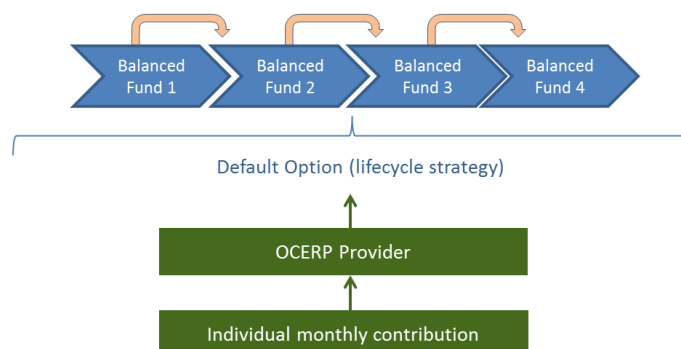


Chart 17 illustrates a life-cycle strategy based on a range of balanced funds, each offering a pre-defined risk/reward profile. At any point in time, all assets are invested in a single balanced fund but, over time, the accumulated capital and the new contributions are moved from one balanced fund into another, whose asset allocation is deemed appropriate for the remaining investment period. The more gradual the switching process is, the more the market effects are smoothed out.

An alternative approach of building a life-cycle strategy based on a single fund is to offer so-called Target Date funds (TDFs)<sup>15</sup>. In this case, TDF holders remain invested in the same fund during the whole accumulation period, along with consumers of the same “generation”.

A TDF glide path is tailored to a certain “generation” of consumers. Each “generation” invests in “its” fund. This is the fund the holder in that age bucket will usually stay in until s/he retires. Consumers usually select the TDF that most closely corresponds to their planned retirement date. Maturities for TDFs may be spread over time, usually at five-year intervals to reach different generation buckets, which also allows for critical mass and economies of scale. TDFs’ glide paths are built taking into account a number of assumptions for each representative generation.

Each TDF is designed to manage a risk/reward allocation based on its maturity. Therefore, throughout the life of the TDF, holders should preferably stay with their initial choice of fund until it matures.

Although TDFs are not tailored to the individual risk tolerance of a particular consumer or a consumer’s particular circumstances, the consumer can choose a TDF - or switch into other TDF - maturing earlier or later, in accordance with his/her more conservative or aggressive risk profile, respectively.

In the USA<sup>16</sup>, for instance, TDFs can be structured to reach their final, most conservative asset allocation in the target date (so-called “to”-funds) or beyond the target date (so-called “through”-funds). In this latter case, the target date does not mean the date at which the TDF reaches its most conservative asset allocation. This specific type of TDFs is designed to be held beyond the presumed retirement date so as to offer a continuing investment option to the retiree who does not intend to make sharp withdrawals at retirement.

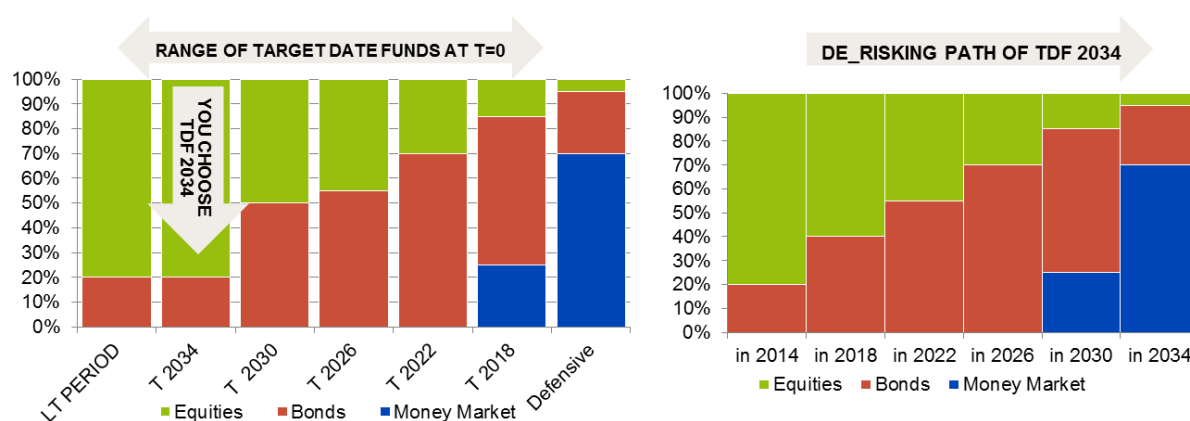
The charts below illustrate a range of TDFs with a pre-determined glide path in accordance with the target date of the fund. The example provided in the chart on the left side illustrates several TDFs offered by a provider. The so-called “Defensive” TDF is for members with a short investment horizon (around 2 years). The so-called “Long-term” TDF is directed to members with a long-term horizon (more than 20 years) to be invested in diversified assets. The chart on the right side illustrates the glide path of the TDF 2034, specifically.

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<sup>15</sup> Bloomberg has a publicly available range of information on all listed TDFs in the world, namely related to assets under management, performance, fees, and top holdings. More information available here: <http://www.bloomberg.com/markets/funds/>

<sup>16</sup> In the USA, target date funds are used as the default option in 70% of workplace pension plans (SEC, 2013).

Chart 18: Target Date Funds



### 5.2.3. The design of the glide path

When designing the glide path of life-cycle strategies, providers typically develop a model using modern portfolio theory, including the principles of diversification and asset allocation and test the model through extensive simulations over various market conditions. Providers may periodically review the assumptions and historical information underlying their life-cycle strategies and make adjustments over time.

Life-cycle strategies usually use a pre-determined glide path, i.e. a pre-defined de-risking strategy which reduces automatically the exposure to “growth” assets (equity) towards “conservative” assets (fixed income) as the date of retirement approaches. To avoid allocation discrepancies relative to the pre-arranged glide path caused by market fluctuations, the percentage weightings in the assets/fund mix are corrected during the year by rebalancing allocations between the assets/funds typically on a monthly or quarterly basis. This type of strategies are commonly called **deterministic life-cycle strategies**, as they do not take into account factors such the degree of risk aversion or the correlation over time between the individual’s salary and the stock market.

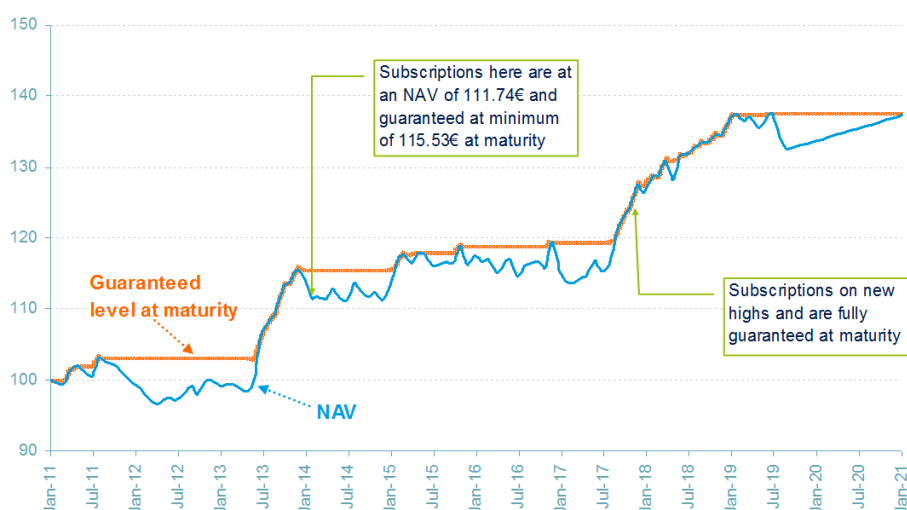
A more sophisticated variation of the life-cycle approach is what is known as a **dynamic life-cycle strategy**. This involves considering other factors beyond age in the design of the glide path. In order to limit the volatility levels, the glide path can be defined by the risk buckets allowed for each phase. This allows for the use of an investment strategy where views of financial markets’ performance are taken into account but targeting a long-term volatility level. A dynamic asset allocation can also take into account labour income, inflation, interest rates and equity premium. Furthermore, a dynamic change in the allocation between growth and conservative assets can be based on the cumulative portfolio performance relative to a set target accumulated capital.

As there is no single “ideal” allocation, glide paths will differ among providers in their initial allocation to equity, in the point in time at which they reduce equity exposure, in the point in time at which they reach their most conservative portfolio allocation and in whether they follow a pre-set de-risking asset allocation or an actively managed asset allocation along the glide path to respond to prevailing market conditions (dynamic strategies).

Whilst some providers focus their offering on generating returns through a more aggressive asset allocation in early saving years and preserving assets closer to the retirement date, others may emphasise the need to minimise capital losses. For instance, some providers offer life-cycle strategies with a **guarantee** at the end of the investment period. As chart 19 below shows, this is done by securing and protecting any capital gain against future possible market downturns, with a guarantee equal to the highest NAV reached during the investment phase.

It should be noted, though, that minimum return guarantees tend to come at a high cost, as explained by an OECD study.<sup>17</sup> This study shows that only relatively high minimum return guarantees would reduce market fluctuations in replacement rates. The study considers that only insurers willing to bear more risk than the average market aversion to risk (i.e. more than other investors) could guarantee such high guarantee returns, which raises the issue of counterparty risk. Overall, an important trade-off between loss mitigation and its cost should be considered when buying a guarantee.

**Chart 19: Guaranteed TDFs**



### 5.3. Considerations for the regulation of default life-cycle strategies

If the authorities consider life-cycle strategies as a suitable default option, thought should be given to base their regulatory framework on the following principles:

- **The rules to guide providers in the design of a life-cycle default option should focus on high-level principles.** The EU legislative framework should provide a definition of a life-cycle strategy in the way proposed by EIOPA, i.e. a life-cycle strategy is one that keeps somewhat riskier assets in the early stages of the pension lifetime to achieve capital growth and, as the pension holder is close to retirement, it switches to a more conservative approach designed to consolidate the capital growth already achieved and avoid market volatility. The EU legislative framework should leave it to the provider to (i) define the glide path, (ii) choose a pre-determined or a dynamic allocation strategy, (iii) opt for a mix of funds or a single fund,

<sup>17</sup> OECD (2009: 8, 9). IOPS (2012) also alerts to the cost of an insurance protection.

and (iv) make an active choice of investments across different asset classes and different markets.

- **The communication material should help the consumer understand the glide path of the default life-cycle s/he is being offered.** The glide path of a life-cycle strategy being offered as a default option should be presented in the pre-enrolment communication material in the ‘investment policy’ description. This should help the consumer understand the asset classes being used and the level of risky assets s/he will hold a few years before retirement.
- **Providers should offer only one glide path strategy.** In case of Target Date Funds (TDF), each provider should be able to offer a range of TDFs organized by five or ten year increments that can fit the holders’ expected retirement date (e.g. TDF 2020, TDF 2025, TDF 2030, etc.). However, the provider should be required to offer one glide path for each target date to ensure that people won’t have to make any choice when opting for the default option.

## 5.4. Fixed-portfolio strategies: alternative to life-cycle strategies

### 5.4.1. Introduction

Besides life-cycle strategies, there are other default investment strategies in defined-contribution pension plans which aim at maintaining the same asset allocation over time.<sup>18</sup> These are commonly referred to as “fixed portfolio strategies”, which are designed as investment funds and differ in terms of their exposure to market risk<sup>19</sup>. IOPS (2012) distinguishes between three types of such default funds:

- **Conservative funds**, which aim at exposing members to little risk. This means that they are mostly/only exposed to low risk assets, with few or no equity investments.
- **Guarantee funds**, which involve a guaranteed (though limited) return, which could be a capital (or no negative return) guarantee.
- **Balanced funds**, which target a mix of stocks and bonds (for instance, 60%-40%), and rebalance their holdings periodically to keep the mix of stocks and bonds in the portfolio on targets.

The main disadvantage of conservative funds is that they tend to take too little risk and therefore limited retirement incomes.<sup>20</sup> Guarantee funds face the same problem as conservative funds, and the cost of the insurance is an additional challenge.<sup>21</sup> In this context, it is not surprising that balanced

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<sup>18</sup> See OECD (2010).

<sup>19</sup> See Viceira (2007).

<sup>20</sup> Gomes et al. (2008) shows that a portfolio fully invested in bonds leads to significantly lower asset accumulation and consumption over the life-cycle, particularly in retirement, than both balanced funds and life-cycle strategies.

<sup>21</sup> See IOPS (2012).

funds are considered as the main alternative to life-cycle strategies when discussing the design of a default investment strategy for defined-contribution pension plans.

#### 5.4.2. Comparing the relative performance of fixed-portfolio and life-cycle strategies

Much research has been devoted to look at how life-cycle and fixed-portfolio strategies perform. This section highlights important factors to take into account when assessing the relative merits of these two types of default options. This analysis is based on recent research papers.

A number of studies show that fixed-portfolio strategies tend to generate a higher level of retirement wealth than life-cycle strategies. However, they achieve this result by leaving consumers more vulnerable to market downturns when they are nearing retirement age.<sup>22</sup> Or, put differently, life-cycle strategies tend to reduce the variability of wealth outcomes, but at the cost of producing lower retirement wealth than what participants can potentially accumulate by keeping the initial (mostly equity-based) asset allocation unchanged until retirement.<sup>23</sup>

The intuition behind this result is clear: based on the evidence provided by historical returns, equity provides superior returns than bonds, on average. Therefore, it may be advantageous to keep a relatively high exposure to equity up to retirement age. However, the higher return of equities comes with higher risk. Hence, consumers who want to protect themselves against the risk of severe market downturns towards the end of their careers, need to consider reducing the proportion of equity as the planned retirement approaches.

The question of whether a life-cycle strategy would indeed be optimal for consumers has been analyzed in recent research papers. Poterba et al (2009) find that life-cycle strategies generate slightly higher expected utility than fixed-income strategies. The OECD (2010) shows that life-cycle strategies perform better than fixed-portfolio strategies in the sense that they provide a higher replacement rate for a given level of risk as measured by the 5<sup>th</sup> percentile, i.e., replacement rates simulated for the given investment strategy below the risk measure only occur with a 5% probability.

The literature shows that the relative performance of life-cycle strategies is very sensitive to several factors:

- **The overall equity exposure:** when comparing different investment strategies, it is essential to ensure that they all have identical average exposures to equities to allow a proper, risk-adjusted performance evaluation. Following this approach, Poterba et al (2009) show that the retirement wealth distribution from balanced funds and life-cycle strategies - with a lifetime weighted average equity asset allocation equal to the equity share of the balanced fund - are similar. More explicitly, the mean wealth and the risk from life-cycle portfolios is very similar to that from the balanced fund.<sup>24</sup>
- **The investment horizon:** It is well established that “bad” outcomes associated with equity investment become less likely as the holding period increases. Indeed, over the long-run, low

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<sup>22</sup> See, for instance, Basu and Drew (2009), Pang and Warshawky (2008) and Pfau (2010).

<sup>23</sup> See Basu and Drew (2006)

<sup>24</sup> OECD (2010) also stress that any comparison of performance is only meaningful when comparing investment strategies with the same overall risk exposure to equities.

rates of return during some periods are balanced by higher returns in others. The OECD (2010) underlines this by observing that the shorter the contribution period is the more protection life-cycle strategies offer. This implies that longer contribution periods reduce the implicit attractiveness of life-cycle strategies.

- **The degree of risk aversion:** Poterba et al (2009) show that at modest levels of risk aversion, the historical pattern of stock and bond returns implies that the expected utility of an all-stock investment rule is greater than that from more conservative strategies. The OECD (2010) confirms that for very risk averse individuals, a strategy of investing exclusively in inflation-indexed bonds of the right maturity would deliver the closest to a riskless benefit, in the sense that the replacement rate would not be affected by fluctuations in asset prices and inflation during the accumulation phase.
- **The level of nonretirement savings wealth:** Poterba et al (2009) show that when the consumers have access to financial wealth other than retirement savings and/or housing wealth at retirement, they are less averse to holding high fractions of their wealth in stocks.
- **The labor income profile:** an extensive literature has found that younger investors should be more tolerant to risk because they have greater flexibility in their subsequent labor supply decisions. For instance, Cocco et al (2005)<sup>25</sup> find that a life-cycle investment strategy that reduces the household's equity exposure as it ages may be optimal, depending on the shape of the labor income profile.
- **The shape of the glide path:** The OECD (2010) shows that life-cycle strategies with a constant exposure to equities during most of the accumulation period, switching swiftly to government bonds in the last decade before retirement seem to perform better than strategies that would reduce the exposure to equities linearly with age or swiftly in the last two decades before retirement. This result is driven by two factors: firstly, for long contribution periods allocations in equities deliver higher returns (as underlined above) and secondly, extreme negative outcomes in equities only have a significant effect on retirement income when they happen in the last years before retirement because it is when people have large amounts of assets accumulated for retirement.

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<sup>25</sup> See Cocco, Gomes and Maenhout (2005).

## 5.5. Default options and payout solutions

### 5.5.1. Assessing default options in connection with payout solutions

It is generally accepted that personal pensions should be primarily designed to provide a source of retirement income to complement other sources. To ensure that this is the case, one of the standards proposed by EFAMA in its 2013 report foresees that EPPs offer a range of solutions for the payout phase, including

- **Annuities**, which are designed to provide payments to the holder at specified intervals, usually until death.
- **Lump sums**, which provide a one-time payment for the total value of the accumulated capital in the pension product.
- **Phased drawdown plans**, which provide periodic payments, typically progressively diminishing the capital by using a systematic withdrawal pattern.
- **Integrated payout products**, which combine certain characteristics of annuities and drawdown plans.

It is logical to wonder whether the choice of a specific payout solution should influence the choice of a default investment strategy. IOPS (2012) has addressed this question and concluded that where the purchase of an annuity is mandatory, a default which results in a large holding of bonds which match annuities would be appropriate. The OECD (2010) has confirmed this recommendation by showing that when the payout phase is a life annuity or an inflation life annuity, life-cycle strategies provide a good trade-off between return and risk. IOPS (2012) also argues that if the accumulated retirement savings can be used for a phased drawdown plan, a default which leave some exposure to growth assets at retirement may be considered more appropriate.

### 5.5.2. Considerations on the choice of a payout solution

No optimal payout solution exists, as a number of trade-offs need to be balanced:

- **Annuities** offer protection against longevity risk but tend to deprive the retiree of bequest opportunities, control over assets as well as the flexibility in the use of accumulated assets.
- **Lump sums** have the advantage of giving individuals the possibility to decide how to convert their accumulated savings into a retirement income. The drawback of this solution is that it does not guarantee that people will make good use of their savings.
- **Phased drawdown plans** expose the retiree to both longevity and investment risks, but have the advantage of providing retirees with greater control over their assets and the opportunity of bequeathing any remaining assets to a beneficiary. In addition, drawdown plans offer



potentially higher retirement income resulting from superior investment returns and greater opportunity to hedge against inflation by using a diversified portfolio, which can also be adjusted to suit the preferences of the individual.

- **Integrated payout products** provide both guaranteed retirement payments as well as the flexibility, bequest potential and upside investment potential of non-pooled solutions.

Given the number of factors involved in assessing the choice of a payout solution, it is not surprising that member states often have different views on the type of the payout solutions they propose or impose in their legislation.

In seeking to assist governments strengthening retirement income adequacy in a defined contribution environment, the OECD Working Party on Private Pensions has noted that *“a certain level of annuitization of balances accumulated in DC pension plans should be set as the default mechanism for the payout phase, unless pay-as-you-go public pensions or the old-age safety provide for sufficient regular pension payments”*.<sup>26</sup> At the same time, the OECD recognizes that the annuity market is not sufficiently developed and recommends that *“competition among different providers in the market for individual and group annuities should be promoted to ensure cost-efficient provision for plan members”*.<sup>27</sup>

Another consideration to take into account when establishing a set payout solution by law is the impact of the rise of life expectancy. Indeed, it is increasingly recognized that, at retirement, the best payout solution should ensure that a significant proportion of pension assets is kept invested in well diversified equity portfolios and the equity exposure is reduced progressively over time. Maurer and Somova (2009) show that this strategy results in significantly higher consumption possibilities, at a relatively low risk compared to immediate full annuitisation at retirement.

### 5.5.3. Policy implications

The following conclusions may be drawn from the above analysis:

- Where the existing regulation prescribes the annuitisation of the accumulated retirement capital, life-cycle strategies seems to be the best default option. By switching to fixed-income instruments as retirement approaches to keep portfolio volatility under control, these strategies can help to protect the value of accumulated savings from severe falls in market prices.
- Where a draw-down plan is the chosen payout option, fixed-portfolio strategies (balanced funds) appear as a better alternative, as they can continue to invest part of the capital in riskier assets.

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<sup>26</sup> See OECD (2012).

<sup>27</sup> CEPS-ECMI (2013) also notes that legislation needs to provide some flexibility regarding the timing for conversion into annuities, as a short-term drop in annuity conversion rates can be very detrimental to beneficiaries.

Optimal retirement investment calls for considerable stock investment at the beginning of retirement. Hence, where policymakers favour annuitisation, then the upper age limit for compulsory annuitisation should be pushed towards 85 in order to achieve a right balance between the objectives of securing a sufficient level of retirement income and protecting retirees from longevity risk at very old ages.<sup>28</sup> Following this approach, life-cycle strategies may be appropriate for people not only throughout their careers but even during retirement to ensure that the allocation to equities remains relatively high at retirement age. An alternative strategy could be to hold a balanced fund until the age of 60 or 65 and to switch to a life-cycle strategy thereafter.

Given the differences between pension systems in Europe, it may prove difficult to reach a consensus at the European level in favour of one specific type of payout solution. Against this background, EFAMA recommends that the EU framework for personal pension products allows member states to decide the types of payout solutions that should be offered to individuals interested in accumulating retirement savings in an EPP.

## 5.6. Conclusions

The above analysis indicates that there is no “one-size-fits-all” default investment option. The relative attraction of life-cycle strategies compared to fixed-income strategies depends on a range of factors, including consumers’ circumstances, the nature of the pension system as a whole and possible restrictions on the type of solutions which may be used during the payout phase. This means that default strategies will always be, to some extent, a “middle of the road” compromise.

This conclusion should not lead the European authorities to renounce the whole idea of introducing a default option in the EU framework for personal pensions. The introduction of a default option is indeed needed as a response to concerns about the ability or willingness of individuals to decide which investment option to choose when saving for retirement.

The choice of the optimal default option could be based on member states’ views on the ultimate purpose of a default option. According to IOPS, this involves a decision between protection and an adequate pension.<sup>29</sup>

If the objective of policymakers is to protect people close to retirement against extreme negative outcomes, life-cycle investment strategies can be considered as an appropriate default. This is one of the recommendations made by the OECD in its “Roadmap for the good design of defined contribution pension plans”.<sup>30</sup> For its part, IOPS (2012) argues that life-cycle strategies “*are generally designed to be appropriate for the broad mass of pension fund members and therefore may be considered suitable as the default in all types of pension system*”. Presumably, IOPS took this position on the basis that the majority of people needs to be protected from severe losses when they approach retirement. Life-cycle strategies reaching their most conservative asset allocation at the legal retirement age would enable this objective to be achieved.

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<sup>28</sup> This is one of the key recommendations developed by Maurer and Somova (2009).

<sup>29</sup> The IOPS places great emphasis on this point. See IOPS (2012).

<sup>30</sup> See OECD (2012).

If providing additional retirement income is the goal, a balanced fund involving some higher risk assets throughout the accumulation phase may be seen as appropriate.<sup>31</sup> A combination of a balanced fund until retirement age and a life-cycle strategy thereafter could also be considered.

If no consensus can be reached at the EU level on what needs to be achieved by a default option, policymakers should contemplate allowing both life-cycle and balanced funds as appropriate default options. The EU framework could also allow member states to require that either life-cycle strategies or fixed-portfolio strategies be offered as a default option in their jurisdiction.

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<sup>31</sup> IOPS (2012).



## 6. Communication Requirements for EPPs

### 6.1. Introduction

This section intends to contribute to EIOPA's advice specifically on common transparency and disclosure measures. It focuses on the information that should be presented to EU consumers before they buy an EPP, as well as during the accumulation period and at/during the payout phase.

EFAMA's considerations on the information disclosure are inspired by the standards for communication from its 2013 Report, which are presented in the table below. These standards for communication aim at promoting transparency and protection to the final consumer. From the point of view of the provider, such standards allow a broader and easier accessibility of an EPP to EU consumers.

**Table 2: EPP standards for communication**

Standards	Rationale
<b>18. Clear and consistent pre-enrolment information</b>	<ul style="list-style-type: none"><li>- Helping individuals to make an informed choice</li><li>- Facilitating comparability between investment options</li></ul>
<b>19. Accessible annual statements</b>	<ul style="list-style-type: none"><li>- Providing useful information on a consistent basis</li><li>- Helping to manage expectations of EPP holders</li></ul>
<b>20. Full transparency on all costs</b>	<ul style="list-style-type: none"><li>- Informing EPP holders</li><li>- Ensuring fair and transparent competition</li></ul>

Source: adapted from "The OCERP: a proposal for a European Personal Pension Product", EFAMA (2013).

In general, EFAMA believes the information given to potential holders and holders should be: regularly updated; written in a clear manner, using clear, succinct and comprehensible language, avoiding the use of jargon and avoiding technical terms where everyday words can be used instead; shall not be misleading and consistency shall be ensured in the vocabulary and content and should be presented in a way that is easy to read.

In its preliminary report to the Commission<sup>32</sup>, EIOPA identifies the key elements to be displayed in relation to the different phases of savings into EPPs. EIOPA's specific views on the issue are summarised in the table below.

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<sup>32</sup> EIOPA (2014b).

**Table 3: EIOPA's advice on information disclosure**

<b>EIOPA's View on Information disclosure</b>	
<b>1. Information to potential holders</b>	<ul style="list-style-type: none"> <li>- KIID<sup>33</sup> and KID<sup>34</sup> shall be used as starting points for developing pension specific disclosure documents</li> <li>- Key elements from KIID: identification of the provider, objectives and investment policies, performance scenarios, costs and charges, risk/reward profile, practical information, and cross-references</li> <li>- Strong need for detailed cost disclosure, possibly through a synthetic cost indicator</li> <li>- Critical question: what should be the level of disaggregation of pension charges?</li> <li>- EU-wide standardized indicator of performance is desirable</li> <li>- Future projection is desirable</li> <li>- Information should be useful in order to make decisions when different choices are available</li> </ul>
<b>2. On-going information to holders</b>	<ul style="list-style-type: none"> <li>- Critical questions: is the pension on track to meet future perceived needs? If not, what can be done to rectify the situation?</li> <li>- Individualized information should be given on contributions made, charges paid or deducted, net returns over certain periods of time, and projection of expected pensions income at retirement based on 3 scenarios</li> </ul>
<b>3. Point of retirement</b>	<ul style="list-style-type: none"> <li>- Information on available payout solutions</li> <li>- Critical point: individuals need to be informed in advance of retirement, possibly in the preceding few years</li> </ul>

Based on this first assessment of EIOPA's views on the critical elements that should be part of the communication material, the next sub-section summarizes the information items EFAMA believes should be included in EPPs' pre-contractual information. This is followed by a discussion on three key areas to include in all communication to EPP holders: pension projections, pension charges and performance. Finally, this section ends with a number of considerations on the standardised communication rules for EPPs.

<sup>33</sup> KIID refers to the Key Investor Information Document Under that replaced the simplified prospectus for all UCITS since July 2012, under UCITS IV (Directive 2009/65/EC).

<sup>34</sup> KID refers to the Key Information Document for packaged retail investment and insurance based investment products (PRIIPs), established under the PRIIPs regulation.

## 6.2. Information to potential holders: the KIID and the KID

EFAMA believes that standardised pre-enrolment communication would facilitate comparison between EPPs, helping consumers to make an informed and more confident decision in their long-term commitment to save for their pensions.

In its preliminary report to the Commission, EIOPA (2014b) notes that the PRIIPs KID and UCITS KIID will be both used as the starting point for developing pension specific disclosure document to potential personal pension holders. The key information items included in the KIID and the KID are outlined in table 4.

The KIID was developed by the European Commission<sup>35</sup> in consultation with the European Securities and Markets Authority (ESMA) with a prescribed format and content, designed to promote harmonisation and comparability of the essential characteristics of an investment fund. The KIID is a two-page factsheet pre-contractual document which must be provided to consumers prior to their investment decision. Its goal is to provide clear and simple investment information to consumers for them to understand the nature and risks of the fund being offered, its costs and the underlying investment policy.

Given the Commission's intention to create enhanced consumer protection rules for the whole spectrum of investment products, a Regulation on a KID for packaged retail investment and insurance based investment products (PRIIPs) was approved in April 2014, which was inspired by the UCITS KIID. This means that from 31 December 2016, structured product manufacturers and distributors will have to provide retail investors with a KID prior to the purchase of an investment product. Personal pension products have been excluded from the scope of this regulation.

**Table 4: Key information headings of the KIID and the KID**

<b>UCITS KIID</b>	<b>PRIIPs KID</b>
a) Title	a) Title
b) Objectives and investment policy	b) What is this product?
c) Risk and reward profile (Synthetic risk and reward indicator - SRRI)	c) What are the risks and what could I get in return'
d) Charges	d) What happens if the manufacturer is unavailable to pay out?
e) Past Performance	e) What are the costs?
f) Practical information	f) How long should I hold it and can I take money out early?
	g) How can I complain?
	h) Other relevant information

<sup>35</sup> Under the UCITS IV Directive 2009/65/EC.

In its advice to the Commission, EIOPA (2012) identified the items from the KIID mentioned in the table above as being useful for IORPs and reiterated this view for personal pensions in its recent report to the Commission (2014b).

In relation to personal pensions and their risk-reward profiles, EIOPA (2014b) recognises the importance of attributing a risk label to different investment options. It also mentions that a possibility worth exploring would be to attribute a risk label to the investment options according to their investment horizon and not to the level of risk.

EFAMA agrees with EIOPA that the KIID would need some tailoring to be suitable for an EPP. In particular, an adaptation of the existing SRRI from the KIID is necessary. The fact that the Synthetic Risk & Reward Indicator (SRRI) calculation is based on the annualized volatility may be considered too short for pension products. The use of weekly values to calculate NAV returns may also need to be adapted to the long-term nature of pension savings. In terms of the overall risk classification, the 7 SRRI categories that correspond to the volatility range of the investment fund may nevertheless prove to be a useful standardised reference for the degree of risk of the EPP, which would allow comparability and an investment decision that fits the consumer's risk profile.

Also, EFAMA believes that in those cases where an EPP offers several investment options, the pre-enrolment communication document should provide information to the potential holders on the available range of investment options, including the default option, their general investment policies, the rights and obligations of the parties involved and a measure of the risk category associated to each investment option.

### 6.3. Pension projections

In its report on Good practices on Information Provision<sup>36</sup>, EIOPA highlights the importance of pension projections for holders to understand whether their pension savings will provide sufficient income. EIOPA believes that providing the accumulated value of pension savings is not easily interpretable for holders and thus proposes the use of pension projections based on three scenarios (positive, neutral, negative) provided in euros and in terms of purchase power.

Pension projections should tell potential EPP holders how much they can reasonably expect to receive at retirement and should be developed with reference to a "representative holder" when included in pre-enrolment documentation. EFAMA considers that the assumptions used for the calculations should be made available to the potential holder, especially, the assumed annual rate of nominal investment returns and rate of inflation.

Personalised pension projections based on individual data (age, gender, salary, contribution rates, etc.) could be made accessible at the provider's website, where EPP holders could introduce the relevant information to obtain such projections. EPP holders should be advised on the uncertainty surrounding the "best estimate", which is based on assumptions on economic, financial and

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<sup>36</sup> EIOPA (2013c).



demographic variables over a long-term horizon. Once again, EFAMA considers that the assumptions used for the calculations should be made available to the holder.

EFAMA believes that pension projections should only be mandatory in prudential regulation for communication purposes if the underlying assumptions are also specified. Otherwise, there is the risk of an unlevelled playing field between providers, as some will opt for conservative assumptions whilst others will use more aggressive assumptions in order to improve the figures. Differences on the assumptions being used will confuse consumers and put at stake the core intention of providing comparability between EPPs.

## 6.4. Charges

A personal pension provider incurs a number of costs (distribution, administration, fund management and fixed costs) which are then passed onto the personal pension holder in the form of charges (advisory fees, entry and exit fees, charges for switching between funds, performance fees, management fees, annuity purchase fees).

The current lack of a standard definition for what should be disclosed as headline charges for personal pensions makes direct comparison of charge levels difficult, which ultimately affects people's willingness to shop around, thus weakening the effectiveness of competition in this market. This is precisely the focus of the EPP standard on "full transparency on costs".

### Box 1

***Standard 11: EPPs should disclose all cost items in a form that individuals can easily understand***

The costs and associated charges of the EPP are of vital importance for prospective holders and should be fully disclosed to support an individual to make sensible decisions about EPPs and compare different EPPs. Information should comprise all items and arrangements whether they are (i) direct or indirect, (ii) one-off or recurring, (iii) at the time of enrolment, in the holding period, or at the end of the saving period.

The EPP provider should formally reconfirm all costs of the EPP to holders annually in an itemized statement in order to keep them informed throughout the different phases of the contract.

*Source: adapted from "The OCERP: a proposal for a European Personal Pension Product", EFAMA (2013).*

Costs are particularly important for pension savings, as they impact the returns, the size of the accumulated balance and therefore the amount of retirement income which can be generated. Given that an annual management charge of 1% of assets under management (AuM) can reduce accumulated pension entitlements by as much as 20% (over a 40-year period), the impact can be substantial (IOPS, 2012). So consumers need to understand the impact of costs on the "value for money" of the pension product they are choosing. Having said this, it is important to recognize that the impact of the charges will depend not only on the level of charges but also on the length of the contribution period, the level and periodicity of contributions and the level of the investment returns.

EIOPA's advice to the Commission (2012) on costs considered the need to provide consistent concepts for "ex-ante" costs, to be disclosed in the KID document, and "actually levied costs", to be disclosed ex-post in the annual statements.

With regard to "ex-ante" costs, EIOPA (2014b) alludes to the use of a synthetic cost indicator (SCI). Such an indicator would use a mathematical model or type of algorithm to provide an estimate of the level of costs in the form of a single figure, e.g. a percentage of the value.

The SCI is a very similar concept to the Total Expense Ratio (TER) that is used in the KIID. The benefit of a synthetic cost indicator would be the comparison of costs applied by different providers.

"Ex-post" costs would be included in the on-going communication to EPP holders and would thus be individualized in order to allow each holder to understand the weight of costs on his/her contributions. EFAMA agrees with EIOPA that combining actual levied charges with the actual real return may help the holder to understand whether their personal pension product is delivering.

One particular point of concern highlighted by EIOPA (2014b) is how the information should be given to consumers in case of a product composed by several underlying funds. EIOPA's concern is where the mix and match of a number of underlying funds during the life of the contract could modify the risk or the cost profile of the personal pension product. This shall be taken into account when developing a KID for an EPP with a 2-level structure. However, looking at market practice this does not seem to be an issue as Target Date Funds currently marketed in the EU (as UCITS) in the form of funds-of-funds present a single TER ratio in their KIIDs.

EFAMA believes that both potential and effective EPP holders would benefit from an aggregate charge disclosure to allow them to easily compare between investment options and to understand the relative weight of costs on their contributions. The main point, as stressed by EIOPA, is to help people find answers to their key questions in a simple and understandable way by including only the relevant information needed to support their decision-making process. For this reason, EFAMA suggests to disclose "ex-post" costs as an aggregate percentage figure, possibly with a simple breakdown between those costs related to the investment portfolio and those related to the insurance guarantees, if applicable. We believe this can help the consumer understand the origin of the costs and in particular those linked to certain types of risk coverage.

When considering the possibility of capping charges, EIOPA (2014b) carefully weights the advantages and disadvantages of such caps. In some countries, charge caps have been set on management fees or on the overall charge structure. However, IOPS (2008) considers that caps can send ambiguous signals as although they prevent products with excessive charges from being offered in the market, they may define as acceptable a particular level of charges that is well above the minimum possible, thus limiting competition and harming the final consumer. The effect of the presence of charge caps on market dynamics and, in particular, on the incentives for a holder to understand their own costs is therefore particularly debatable.

Lastly, the relationship between charges and performance needs to be carefully considered as the cheapest personal pension is not necessarily the one offering the best returns and should not therefore be automatically considered as the appropriate default (IOPS, 2012).

Indeed, there is no simple equation between low cost and value for money. Charges can pay for good quality financial advice and other services that may be an extremely beneficial product feature. Nonetheless, charges are clearly an important consideration in the delivery of good outcomes for members of DC schemes.

## 6.5. Performance

Although EIOPA (2014b) argues that past performance is not an ideal metric for potential personal pension holders under the argument that the link between past performance and future performance is weak, EFAMA believes that past performance should be part of pre-enrolment information for EPPs as it is one of the points that potential EPP holders use when comparing investment options, serving also as an indicator of a fund manager's performance against his peers operating in the market. The disclosure of past performance figures fosters competition between EPP providers and their capacity to deliver, which is always beneficial to the final consumer.

The format and content for past performance information on a pre-enrolment EPP document could be drawn from the KIID, which presents a chart format that lays out the fund's performance for the last ten years, where available (where a fund is less than one-year old, no performance history must be shown). The chart is accompanied by a description that explains that "past performance is not a guide to future performance" and an indication of the costs that have been taken into account in the calculation of past performance.

When included in the on-going communication material, information on past performance empowers members to understand whether their EPP is delivering. Also, past performance should allow the holder to have a holistic view of his/her investment returns instead of the performance of each component (fund) of his/her investment portfolio, where applicable.

EIOPA (2014b) believes that future projection of performance would help potential holders to understand the workings of the product but under a clear warning that the projections are not guaranteed. Here, EFAMA believes that future projections can only be fairly used for comparison purposes if the assumptions are standardized for all personal pension providers, otherwise there is the risk of very low or no comparison between personal pensions' expected performances.

## 6.6. Considerations on communication rules for EPPs

- **Standardised communication provisions for EPPs should allow for transparency, simplicity and comparability.** Standardised pre-enrolment communication requirements play an important role for personal pension savings decisions as they allow for a comparison between products, encouraging consumers to shop around for the most suitable EPP. On-going communication material should help EPP holders understand whether their pension savings are aligned with their pension income targets and should also help holders decide, before

retirement, on the most adequate payout option to choose. In this context, EPPs' communication material could cover: i) marketing material for potential holders (along the KIID lines), ii) annual statements for holders, iii) pre-retirement communication with information on the payout options available as well as the possibility to remain invested and coordinate this with a payout option, and iv) post-retirement communication with information similar to the annual statements in case the retiree remains invested and / or information on the benefits to be paid.

- **Pre-enrolment communication should disclose the most relevant features of each investment option.** For an EPP offering a choice between different investment options, the communication to potential holders could include a short description of each investment option and the risk-reward profile of each investment option, accompanied by a statement that this risk indicator is not a reliable indication of the future risk profile of the investment option. The computation of the synthetic indicator should be adequately documented and providers can make that documentation available to holders on request.
- **EPP providers should provide annual pension statements.** The annual pension statements could contain an annual balance of the accumulated capital, contributions, “ex-post” costs and investment returns referring to the previous year. If a guarantee is provided in one of the investment options, the annual pension statement should explain the nature of the guarantee and current level of accrued entitlements vis-à-vis the mechanism protecting those.
- **Simple and standardised information on charges should be included in the pre-enrolment and annual pension statements.** In order to make costs simple and understandable to the EPP holder, communication statements could include the aggregated value of costs referring to the previous year. This should help consumers compare one figure on costs between different EPPs and to understand the relative weight of costs in their overall contributions. EFAMA also suggests to include a simple breakdown between costs related to the investment portfolio and those related to the insurance guarantees, if applicable. We believe this could help the consumer understand the origin of the costs and in particular those linked to certain types of risk coverage.
- **Information on past performance should be included in the pre-enrolment and on-going communication material.** Information on past performance for all EPPs/investment options should be provided in the pre-enrolment communication material for potential holders. A statement should be always included, warning about its limited value as a guide to future performance and indicating the costs and the currency used to compute past performance. Where a material change occurs (investment policy, objective), the period prior to the material change should be indicated on the chart and labelled with a clear warning that the performance was achieved under circumstances that no longer apply. Finally, where a holder changes investment option, the past performance of the new investment option should be shown. EFAMA considers that information on past performance in the on-going communication material empowers holders to understand whether their EPP is delivering.

## 7. Distribution Requirements for EPPs

While improvements in information disclosure are essential to empower consumers' decisions, rules on selling practices are essential to protect consumers' interests. In its preliminary report to the Commission, EIOPA recognizes the importance of standardised distribution rules for personal pensions. In this context, EIOPA recognises the existence of EU requirements in the Market in Financial Instruments Directive (MiFID) and Insurance Mediation Directive (IMD) but alerts to the need to adapt the concept of suitability/appropriateness to pension products.

Distribution requirements are already regulated at EU level in Directives such as IMD and MiFID, both containing provisions in relation to selling practices and professional requirements.

In a nutshell, the provisions in IMD are articulated in the context of the provision of advice to the customer. IMD also contains provisions concerning professional requirements that apply to insurance intermediaries. The IMD2 proposal strengthens these requirements. In MiFID there is a general principle to act honestly, fairly and professionally in accordance to the best interests of clients. In the MiFID II proposal, firms are required to collect specific information to enable them to assess suitability and appropriateness of products and services to clients.

The 2013 EFAMA report included a standard on distribution requirements for an EU-wide personal pension.

### Box 2

#### ***Standard 14: Uniform rules on advice should be applied to EPPs and all other personal pension products***

Given that the choice of a personal pension product is one of the most important financial decisions a consumer makes, adequate advice should be provided at the point of sale, avoiding conflicts of interests. The goal is that advice should be honest and unbiased as a general principle, given that the provider always has to act in the best interest of the EPP holder.

The rules on advice for personal pension products should be harmonized at EU level and should be aligned with the appropriateness and suitability tests established in the Markets in Financial Instruments Directive (MiFID) (Directive 2004/39/EC) and the rules set in the Insurance Mediation Directive (IMD) (Directive 2002/92/EC). As these Directives are being reviewed, EFAMA believes it is good time to ensure both Directives converge on the same rules for all personal pension products.

*Source: adapted from "The OCERP: a proposal for a European Personal Pension Product", EFAMA (2013).*

In its Preliminary Report, EIOPA (2014b) agreed that the MiFID and the IMD2 proposals are particularly relevant for personal pensions. However, EIOPA believes that suitability/appropriateness concepts should be adapted because a rigid application to personal pensions of the principle "buy only what

you understand” may discourage participation in personal pensions. EFAMA strongly agrees with this viewpoint. EFAMA also shares EIOPA’s position that receiving “value for money” should be central to any assessment of suitability advice/appropriateness in this area.

With regard to independent professional advice, EIOPA considers that the potential personal pension *“holder should only be sold a product with the benefit of independent professional advice”*. This is consistent with the position presented in the 2013 EFAMA report. However, EIOPA argues that *“this argument becomes less convincing when dealing with standardized products”*. EIOPA also suggests that *“generic advice suitable for the vast majority of citizens could be developed through web-based solutions for dissemination of information and contributing for standardized products”*.

EIOPA also considers that professional requirements should depend on the degree of product standardization, the level of safeguards built into the standard pension solutions, and the extent to which they can be aligned with the overall potential personal pension holders.

EFAMA agrees with EIOPA that the level of advice accompanying the sale of EPPs should be calibrated to their level of standardization. If EPPs could be sold without the requirement to receive investment advice, the cost to be borne by the holders would be lower. Therefore, there is a trade-off between the protection offered by professional advice and the increased real returns on investments that may be expected from reduced costs.

EFAMA believes that while the framework for consumer protection should be robust, the costs related to advice in pension savings should be also taken into account.

Lastly, all information in regards to the characteristics of an EPP should be defined in the communication requirements rather than in the distribution obligations. This refers, in particular to the existing penalties for early withdrawals, the payout options, and the possibility to switch between investment options or between providers. Any distribution rules for EPPs should be focused on suitable advice and professional requirements for providers that could ensure that the sale of EPPs are in the best interest of the final consumer.

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