Single market for personal pension products and consumer protection issues*

*Ján Šebo, Tomáš Virdzek and Ľubica Šebová***

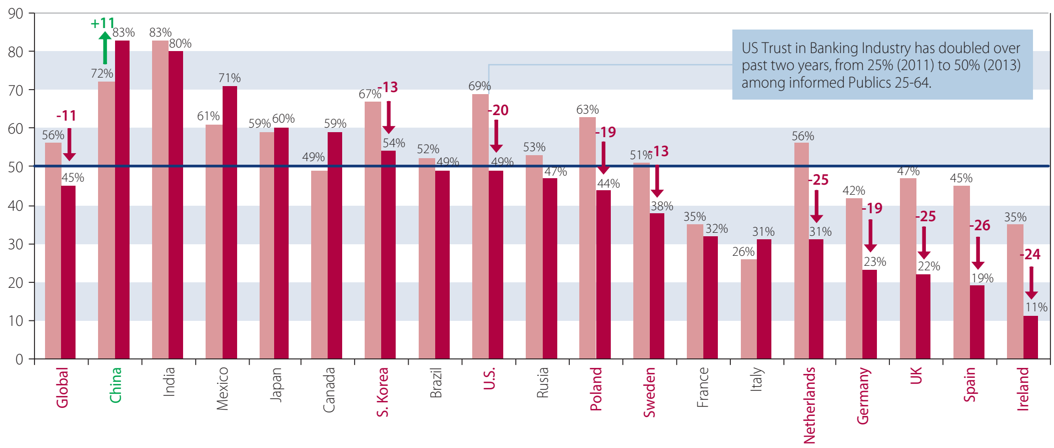
EIOPA[1] (2014) in its Preliminary Report on personal pension products (PPPs) identified that creating a second regime for PPPs could be considered while the baseline should be built on standardized products that allow wide coverage and full comparison. A large majority of stakeholders recommend/argue in favor of EIOPA working principally or indeed only on defined contribution of personal pension products (DC PPPs). Many of them refer to the prolonged trend away from defined benefit (DB) schemes and towards defined contribution (DC) schemes. It shall be argued that DB PPPs would be too complex for a regulation aiming at a single market, in particular with respect to transferability and portability including difficulties with respect to capital requirements. The focus on DC PPPs is therefore viewed as more appropriate if products are intended to be sold cross-border or for self-employed people. However, the point of savers should be taken into account, where the PPPs are not viewed as a DC or DB products, but as a long term contract signed between the saver and a provider, where the product should allow for an adequate income replacement ratio (IRR) when old. Under this contract, the saver carries the most of the risks. PPPs should be therefore recognized on the amount and level or risks shifted from provider onto saver.

If the PPPs is not straightforward for the ultimate aim (adequate IRR) and the risks are shifted onto saver[2], than the PPP as a product should have „no strings attached" and full information disclosure on the risks associated with the PPP should be presented.

Ján Šebo

The ongoing debate on PPPs should take into account the issues associated with behavioral aspects of savers' decision-making and ability to motivate savers to enter into long-term contract with the financial provider[3]. According to many recent as well as seminal studies (i.e. Arrow, 1974[4], Kahnemann and Tversky, 1979[5]), the trust is one of the components consumers buy together with the product. As the trust in financial sector and subsequently in the long-term savings products is generally low, the consum-

Trust in financial sector (in percentages; in percentage points)



Source: Edelman TrustBarometer, 2014.

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** Authors are researchers at the Faculty of Economics, Matej Bel University in Banská Bystrica, Slovakia.

1 EIOPA. 2014. Towards an EU single market for personal pensions. An EIOPA Preliminary Report to COM. EIOPA-BoS-14/029 (available at: https://eiopa.europa.eu/fileadmin/tx_dam/files/publications/reports/EIOPA-BoS-14-029_Towards_an_EU_single_market_for_Personal_Pensions-_An_EIOPA_Preliminary_Report_to_COM.pdf)

2 EIOPA Report on risks related to DC pension plan members, CEIOPS-BOS-11/024 (final), 8 July 2011

3 EIOPA „Good practices on information provision for DC schemes – Enabling occupational DC scheme members to plan for retirement". EIOPA-BoS-13/010. 24 January 2013.

4 K. J. Arrow, The Limits of Organization, Norton, 1974.

5 Kahneman, D., Tversky, A. Prospect Theory: An Analysis of Decision under Risk. Econometrica, 47(2), pp. 263-291, March 1979.

ers face greater level of uncertainty, which turns into inertia.

According to Edelman TrustBarometer (2014) trust in financial sector in EU is at the lowest level (29 %) among all world regions. The similar results regarding the trust in financial sector and its products can be seen in EC Consumer Market Monitoring Survey[6] where the investment services, private pensions and securities are among services with lowest trust overall. On top of that, consumers also suffer from low level of comparability of products. All these aspects contribute to increased uncertainty and low expectations of consumers in these products.

However, there are misinterpretations of inertia within the financial sector claiming that consumers are conservative investors. Instead of regaining the trust in products financial sector sell to consumers, it is easier to claim the conservative risk-reward profile of consumers. When considering the long-term investment (savings) horizon, risk capacity of consumers has been left behind supported by poorly managed pension funds not able to beat even the simple passive exchange traded funds (ETFs). When talking about the inflation, there are only few long-term savings products on EU market able to beat the inflation index. This has led in creation of complex products,

6 http://ec.europa.eu/consumers/consumer_research/consumer_market_monitoring_survey_en.htm

Table 1 "Objective-information/Risk-protection" scheme for PPPs

Phase	Objective	Information disclosure	Risk	Protection standards
1. Pre-contractual (Joining)	Adequacy Ability to align the product features with obligations and the objective (adequacy)	1. Individual stochastic modeling of the consumer life-cycle under the different PPPs (including all charges during the whole life-cycle)	A. Understanding of the PPPs by consumer B. PPP Suitability risk	Obligation of industry (provider, intermediary) to present individual stochastic based model of adequacy under different PPPs life cycle
			C. Contribution level	Right to change the contribution level
		2. Structure, source and availability of information (What? Where? How to read?)	D. Information availability	Obligation of PPPs provider to disclose information on all phases prior to signing
			E. Investment (savings) strategy	
2. Contractual (Accumulation)	Path-tracking Convergence with the modeled life-cycle path	1. Regular, time specific and retrievable data on respective risks and parameters of particular PPP 2. Forward-looking information disclosure	A. Market risk B. Inflation risk C. Investment strategy D. IRR deviation risk	Right to switch the PPP for another PPP during the accumulation phase (not withdrawal)
		3. Benchmarking	E. Long-term poor performance	
		4. Full disclosure of charges	F. Charges	Aligned fee policy to limit portfolio managers´ conflict of interest
		5. Income replacement ratio modeling (career path vs. performance of savings)	G. Contribution level H. Low or negative added-value	Right to change the contribution level Right to suspend/pause the PPP for a certain period of time (e.g. due to unexpected unemployment) Supervision fines for "poor" added-value (banning the product)
3. Pay-out (Retirement)	Pension needs Ability to align the product features with the adequacy and individual preferences	1. Life tables and actuarial calculations 2. Comparison tools	A. Longevity risk	Supervision of actuarial models and calculations (under existing regulation)
		3. Regular, time and specific data on respective risks of pay-out products	B. Inflation risk C. Market risk D. Interest risk	Right to switch the product

Source: FSUG (2013[12]).

which significantly underperform the market and leave consumers with high charges and risk of missing the ultimate savings objective.

There are several ways how to limit inertia of savers and their willingness to buy long-term savings products. Regaining the trust by offering simple, low cost passively managed funds using the life-cycle savings approach is one of the most important.

Another issue that should be taken into account when discussing on the possible EU-wide PPPs is the ongoing conflict of interest between financial sector owners, portfolio managers and savers. It becomes obvious that portfolio managers serve the financial sector owners and not the clients when designing the PPPs and running the pension funds. Selling the long-term savings products to consumers which underperforms the market benchmarks (OXERA, 2013[7]; EuroFinUse, 2013[8]) and produce short-term revenues and profits for financial providers via charges cannot remain untouched during ongoing debate.

The fee policies should be based on the benchmarking system that recognize whether the portfolio manager underperforms the market benchmark. In the case of underperformance, the management fee should be lowered to the levels that allow covering only part of the fixed costs. To motivate portfolio managers to start performing in favor of savers, success fee should be introduced. The neutrality of fee policy that allows management as well as success fees should be introduced only if the portfolio manager performs better than a market benchmark. In a case where portfolio manager performs on the level of market benchmark, the fee policy should allow only administration fee that covers fixed and variable costs of providers. Fee policy should therefore serve as a tool for aligning the interest of portfolio managers and savers on the first place. Leveling the fee revenues with the product performance could limit the conflict of interest and short-termism where portfolio managers serve the financial institution shareholders with savers left behind.

The last point that should be considered carefully is the task of regulators. Currently, financial sector claims that the whole sector is overregulated or at least there is different level playing field for different providers. However, the introduction of PPPs on an EU level allows consideration of lowering the regulation of providers and shifting the focus on products. Considering the PPPs as a long-term saving product that has three different phases, the regulation of consumer protection should recognize the rights for consumer specifically for each phase.

The rationale for product regulation imposes the need to recognize the objective of the product and information disclosure that is forward-looking toward this objective (see Dowd and Blake, 2013[9]). Retrospective information has no real value for consumers and only distracts their willingness to contribute to the product in the future[10]. Enforcement of forward-looking information disclosure while accepting the behavioral aspects of savers´ responses to the information (EIOPA, 2013[11]) is a challenging task for regulators.

Combining the objectives with risks and information disclosures could lead to the creation of savers´ rights in the long-term savings products recognized for PPPs. However, it should be noted that information disclosure to savers is still not recognized as one of the prudent principles.

Regulation of the product should be a key task of any regulation. Most of the regulatory attention should therefore be paid to the design, back-testing, forward-testing, projections, distribution, switching, termination and transparency of particular products as they are directly sold to consumers. Simultaneously with the main product oriented regulation, the regulation of providers derived from the product regulation (rules) should be applied. This combined approach with a clear focus on the product regulation should ensure that poor value products are not engineered and distributed on the single market.

There are some good examples and practices that can be used as inspiration for creating a second regime for PPPs with product oriented regulation. We refer to the paper of Kevin Dowd and David Blake[13] (2013), Blake, Cairns and Dowd[14] (2009) and OECD[15] Roadmap for the Good Design of Defined Contribution Pension Plans which was published in June 2012. Some good examples can be taken from the national schemes implemented in Sweden, Estonia, Slovakia or Romania. Additional good example is a 401(k) scheme applied in USA. Some interesting findings on a good design and operation of PPPs can be found in the OXERA[16] Study on Position of Savers in Private Pension Products (2013).

7 Oxera study „Position of Savers in Private Pension Products". Research study prepared for behalf of FSUG and EC. 2013.

8 EuroFinuse. 2013. The Real Return of Private Pensions (available at: http://www.eurofinuse.org/fileadmin/user_upload/documents/Research_Reports/Pension_Study_EN_website.pdf)

9 Dowd, K., Blake, D. 2013. Good Practice Principles in Modelling Defined Contribution Pension Plans. Discussion Paper 1302. The Pension Institute. [online] http://pensions-institute.org/workingpapers/wp1302.pdf

10 Harrison, D. 2012. Treating DC scheme members fairly in retirement? NAPF and Pensions Institute Research Report, February 2012.

11 EIOPA „Good practices on information provision for DC schemes – Enabling occupational DC scheme members to plan for retirement". EIOPA-BoS-13/010. 24 January 2013.

12 Financial Services User Group's (FSUG) Response to EIOPA Discussion Paper on a possible EU-single market for personal pension products.

13 Dowd, K., Blake, D. 2013. Good Practice Principles in Modelling Defined Contribution Pension Plans. Discussion Paper 1302. The Pension Institute. (available at: http://pensions-institute.org/workingpapers/wp1302.pdf)

14 Blake, D., Cairns, A., and Dowd, K. (2009) Designing a Defined-Contribution Plan: What to Learn from Aircraft Designers, Financial Analysts Journal 65 (1), 37-42.

15 OECD Roadmap for the Good Design of Defined Contribution Pension Plans. (available at: www.oecd.org/finance/private-pensions/50582753.pdf)

16 Oxera study „Position of Savers in Private Pension Products". Research study prepared for behalf of FSUG and EC. 2013.