EFI EuroInvestors
The European Federation of Investors
Fédération Européenne des Epargnants

Rue du Lombard 76
1000 Bruxelles - Belgium

www.euroinvestors.org
info@euroinvestors.org

European Commission

Green paper towards adequate, sustainable and safe European pension systems

EFI reply

15th November 2010

Summary

EuroInvestors (the European Federation of Investors or EFI) was created in the summer of 2009, following the financial crisis which demonstrated the limits of the almost exclusive dialogue between regulators and the financial industry, largely ignoring the user side. EFI aims at representing and defending at the European level the interests of financial services users in order to promote training, research and information on investments, savings, borrowings and Personal Finances of individuals in Europe, by grouping the organizations pursuing the same objectives at a national or international level. Already about 45 national organizations of investors and other financial services users have joined us, and EFI already represents about two million European citizens.

EFI fully agrees with the Commission that an "adequate" and sustainable retirement income for EU citizens now and in the future is a priority for the European Union, and that it is also a major challenge to achieve. Therefore EFI welcomes this green paper.

The adequacy of unfunded pensions and of defined benefits ones (even if fully funded) could be defined as the conformity of the results to the initial promise made to the participants.
The adequacy – or at least the fairness – and the sustainability of unfunded pension schemes are problematic even if they are mandatory schemes.

Therefore the "adequacy" and sustainability of funded defined contribution pension schemes becomes even more critical.

"Adequacy" in that case also needs to be more precisely defined. For EFI, it could be their ability to deliver **a net financial performance for the participants that is at least protecting the real value of their retirement savings** (the purchasing power). If not, why propose such pension products?
Contrary to what we often hear, such an adequacy is not guaranteed – to say the least – by

EFI EuroInvestors
The European Federation of Investors
Fédération Européenne des Epargnants

Rue du Lombard 76
1000 Bruxelles - Belgium

www.euroinvestors.org
info@euroinvestors.org

merely pushing citizens to save early for retirement. The more important factor for an adequate pension is the choice of the retirement investment products, as we show in this reply.

This choice is very difficult to make:

- Retail retirement savings products are sometimes the most complex, too often lack transparency, flexibility and transferability, and too many pension funds have governance issues.
- Very few - if any at all - packaged retail investment products even offer/disclose a long term track record, the only time horizon suitable for retirement purposes. Also we do not know of any provider disclosing it on a net basis (net of all charges and taxes), which is a requirement for US retail funds for example.
- The equities markets – a major asset class for pension funds "adequacy" - are being damaged by current EU policies. Fixed income alone is not an "adequate" asset class for investing the bulk of retirement savings, as it does not protect citizens against long term inflation[1].
- Personal long term savings and pension products are excluded from the investor protection benefits of the current European rules (MiFID Directive) and also excluded from the projected ones ("PRIPs" project), although they need them most.
- Even for the few retail long term investment products covered by MiFID securities and investment funds), the information duties and the prevention of conflicts of interests ("inducements") are not really enforced, allowing EU individual investors to be too often very seriously misled as shown in this reply.
- Financial "advisors" – so critical for choosing retirement investments – are most often not "advisors" but sales people and are not independent from product providers, unlike the advisors citizens can get to take care of their physical health decisions.
- The financial education level of EU children and teenagers makes it worse as 18 year olds rarely know for example what an interest rate really is, not mentioning an annuity.

EFI has made and is making proposals to address these major issues.

Also, a pre-requisite is to have accurate and comprehensive information of one's pension rights derived from mandatory schemes. Despite recent efforts this is far from being the case to-day for every EU citizen.

Specific questions

Given the mandate of EFI, these replies will mostly focus on issues related to pension savings and investments.

[1] Except inflation-linked bonds of course, but they usually represent a tiny share of pension funds assets.

Rue du Lombard 76
1000 Bruxelles - Belgium
www.euroinvestors.org
info@euroinvestors.org

***Question 1**: How can the EU support Member States' efforts to strengthen the adequacy of pension systems? Should the EU seek to define better what an adequate retirement income might entail?*

The green book does not define what it means by "adequacy" of pension systems, but it hints at "adequate" retirement income". So, yes, the EU should seek to define it better.
As the green book states, "*Adequacy and sustainability are two sides of the same coin."*:

- The sustainability of unfunded (pay as you go) schemes relying on future taxes or mandatory levies is problematic because of the increasing life expectancy, the high level of unemployment and of public debt, and the inability of these systems to guarantee EU citizens an equitable and fair sharing of the pensions burden between generations. Indeed, to our knowledge, none of these pay-as-you go systems in Europe do publicly quantify the so-called "inter generational solidarity". This problematic sustainability is the major reason why funded schemes and, more specifically funded DC schemes are taking a growing share of pensions. The "adequacy" of unfunded schemes is also very much at stake. Labeling them as a way to ensure "inter-generational solidarity" is not sufficient: this is another term that needs a clear and precise definition, and some measurements.
- The "adequacy" of funded DC (defined contribution) schemes, especially those where participants contributions are not mandatory, could be defined in our view as their ability to deliver **a net financial performance for the participants that is at least protecting the real value of their retirement savings** (the purchasing power). This seems to have been overlooked by European regulators who claim that the participation rate and the age of the start of retirement savings are the most critical "adequacy" factors, omitting this one.
  Evidence (see annex: Long term net financial performance - the primary factor for pensions adequacy and sustainability) shows that this is too often not the case and, in too many cases, blindly applying this "save early" motto leads to the opposite result: the destruction of the real value of EU citizens pension savings. This is so because the age at which you start saving for retirement and at which rate do not matter so much as the choice of the pension investment products. As the green paper states : "*When making saving decisions it is important that individuals be offered appropriate options*." This is a major problem: see our reply to Question 12 below.
  The EC green paper on Retail Financial Services in the Single Market of 30 April 2007 was even clearer: "***Due to the nature of long-term savings and pension plans, particular care is needed to ensure that consumers are being offered products that are really adapted to their needs and marketed appropriately. These are major, once in a lifetime, financial decisions for consumers. Therefore, consumers must be in a position to make their choices in full knowledge of the product, correctly assessing their circumstances and needs."***
  We propose that the EC makes this a top priority again as it was in 2007.

Rue du Lombard 76
1000 Bruxelles - Belgium
www.euroinvestors.org
info@euroinvestors.org

Question 5*: In which way should the IORP Directive be amended to improve the conditions for cross-border activity?*

The Green Book rightly notes that *"Cross-border activity for life assurance products has also remained limited, representing well below 10% of total life assurance premiums written in most Member States.*" The main reason is that there is no such thing as a real single internal market for life insurance products, and this is in turn mainly due to tax barriers inside the EU. Contrary to the free flow of capital principle and to the EU treaties, tax discrimination based on the Member State residency is widespread.
Example: a Belgian saver will not be subject to income tax on the proceeds of a unit-linked insurance contract (branch 23) if he buys it from a Belgian based insurer. He will likely be subject to a 7.5 to 35 % tax if he buys it from a French based insurer.

About other statements of the green paper in this section.

Yes, we agree that it "*could also be helpful in extending access to additional sources of retirement income beyond pensions, such as reverse mortgages."*. But these products would also have to follow the rules mentioned by the EC in its 2007 green paper and quoted above.

It would also be nice to "*create a regulatory framework for an EU-wide private pension regime alongside the existing pension regimes in Europe*"; but the EU authorities should first create a real single market for existing savings and retail investment products by effectively prohibiting these major tax discriminations within the EU.

Question 6: What should be the scope of schemes covered by EU level action on removing obstacles for mobility?

At the very least, all mandatory schemes, where EU citizens have been forced to participate and/or contribute.

Question 7: Should the EU look again at the issue of transfers or would minimum standards on acquisition and preservation plus a tracking service for all types of pension rights be a better solution?

An EU level tracking system could certainly help mobile individuals keep track of their pension rights. Currently, it is often not possible even at the Member State level. For example, although its principle has been established in France, it is still rather poorly implemented.

Question 8: Does current EU legislation need reviewing to ensure a consistent regulation and supervision of funded (i.e. backed by a fund of assets) pension schemes and products? If so, which elements?

Yes, current regulations are very inconsistent between long term and pension products covered by MiFID, Solvency II and IORP directives, and create a very uneven playing field

Rue du Lombard 76
1000 Bruxelles - Belgium
www.euroinvestors.org
info@euroinvestors.org

and inconsistent investor protection (as mentioned in Question 1 above.
First, the IORP Directive does not cover by far all occupational retirement products in Europe. In particular it fails to cover such products when those are subject to member states' insurance regulations. This is all the more problematic as insurance regulated occupational pension products can be very important in quite a few member states.
Second, governance and disclosure are often very poor. The reduction of the volatility of the pension investments when the participant nears retirement is only one of the problems. Again (see Questions 1 and 12 and Annex 1), the medium and long term net financial performance and its disclosure are even more important.

Question 10*: What should an equivalent solvency regime for pension funds look like?*
See reply to question 8 above. It is very detrimental to European savers for retirement to bear very inconsistent solvency rules just because one pension product falls under Solvency II Directive and the other falls under the IORP one.
"*The difference in the ways occupational pensions are delivered: book reserve, pension fund or insurance contract*" cannot justify at all the inconsistent treatment of long term savings and pension products.

Question 12*: Is there a case for modernising the current minimum information disclosure requirements for pension products (e.g. in terms of comparability, standardisation and clarity)?*
It is surprising to us that the EC is asking such a question in 2010, as it had very clearly and very rightly answered it in 2007 in its green paper on retail financial services:

"Due to the nature of long-term savings and pension plans, particular care is needed to ensure that consumers are being offered products that are really adapted to their needs and marketed appropriately. These are major, once in a lifetime, financial decisions for consumers. Therefore, consumers must be in a position to make their choices in full knowledge of the product, correctly assessing their circumstances and needs."

EFI could not agree more.
Unfortunately, not only there were no major regulatory steps from the EC in that direction to our knowledge, but, moreover, personal retirement savings and pension products:
- are excluded from the investor protection benefits of the MiFID Directive, as this well-meant Directive covers only about a fifth of retail investment products and none of the retail long term savings and pension products;
- more worrying, these personal retirement savings and pension products are also currently excluded from the scope of the current EC "PRIPs " (packaged retail investment products) project, which is most unfortunate and clearly inconsistent in our view with the EC 2007 statement.

Rue du Lombard 76
1000 Bruxelles - Belgium
www.euroinvestors.org
info@euroinvestors.org

Even long term investment products covered by the MiFID Directive are too often not adequately sold. Product disclosure, information at the point of sale, widespread inducements and conflicts of interests in the distribution, and the scarcity – to say the least – of genuine financial advice (i.e. independent and competent) are too often very seriously misleading retail investors. The Annex: "Long term net financial performance - the primary factor for pensions adequacy and sustainability" is based on a real case and shows the extent of the damage and of the gap to be filled.

Most retail pension investment products lack a long enough track record. In particular, it is very difficult if not impossible to get fund track records beyond ten years. How can one make any assessment even a low value back testing when there are no or very few and very difficult to access 20 or 30 or 40 years track records ?

The "financial advisor" label must not be allowed for sales people (i.e. financial professionals who derive the major part of their income – directly or indirectly – from selling products and services to their clients).

The retail investors are all the more easily misled as – although long term retail investment products are more and more complex – their ability to understand them is minimal. For instance, as mentioned in the past, most young adults are no longer taught what is an interest rate and how it works at school. Very few if any 18 years olds know what a simple annuity is and how to compute it. But financial distributors are now selling "variable annuities" which they often do not fully understand themselves to the EU citizens.

EFI has proposed and proposes the following to address these dramatic pension issues:

- extending MiFID investor protection principles to all personal pension products;
- Actually enforce existing MiFID provisions on information duties and on inducements;
- Extend, adapt and enforce the principles of UCITS IV product disclosure rules to all long term and pension investment products
- Prevent sales people from presenting themselves as "advisors" to retail investors, a fortiori as "independent advisors"
- Ask the financial industry to simplify its long term investment products offering, build at least a few that last much more than years and make these long track record data easily available.
- Enable every EU citizen to get at least once every five years a truly independent and competent advice on pension adequacy.
- Provide every EU citizen with basic financial mathematics knowledge by the age of 18 latest.

Rue du Lombard 76
1000 Bruxelles - Belgium
www.euroinvestors.org
info@euroinvestors.org

***Question 13**: Should the EU develop a common approach for default options about participation and investment choice?*

This could be interesting, but, as mentioned above, it really depends on the investment product that these features are applied to.

In our view, ensuring that future pensioners are guided to the right pension investment products is a more pressing priority to get an “adequate” pension income.

Additional comments

EFI believes that there are other important issues to address regarding the adequacy of pensions:

- Governance issues at pension funds level.

For example two of the biggest French pension funds (pillar III) are exempted by law to give access of their general assembly to their participants, contrary to all other long term savings and pension associations in France. The consequence is that participants are not consulted on material changes to their pension contract, contrary to all other similar products’ participants.

- Disclosure issues

The same two pension funds do not currently disclose to would-be participants that the pensions provided have been loosing value for many years, as they have not been increased in line with inflation.

- Asset allocation issues

One reason for this – undisclosed – issue could be the portfolio allocation, which is heavily weighted towards bonds. With bond rates around 2 to 3% (Euro Government bonds, the biggest bond asset class in most of these portfolios), the problem is not likely to go away .

- National supervisors governance issue

One of our French members has been alerting the French supervisor on these serious issues, but has not gotten any reply so far. The regulator is Autorite du Controle Prudentiel (ACP). As its name shows (“prudential”), this national supervisor is more concerned with business continuity than with retirement savers protection. In fact, clients are a minority in its newly created “client consultative commission”. More worryingly, clients are not represented in the Authority’s Board (“College”), whereas there are several people from the providers’ side in this Board. The same unbalanced governance is to be found at the other French Supervisor’s board, AMF, except for one representative of employee shareholders. This problem is not limited to France as it has been identified last year by FIN-USE[2]

[2] Consumer voice in financial services: http://ec.europa.eu/internal_market/fin-use_forum/docs/consumer_voice_en.pdf

Rue du Lombard 76
1000 Bruxelles - Belgium
www.euroinvestors.org
info@euroinvestors.org

Annex

Long term net financial performance - the primary factor for pensions adequacy and sustainability

Hard lessons from a real case

We chose a very simple case: the choice between two retail UCITS funds, not complex and opaque personal pension products like deferred or variable annuities:

- Fund A is not actively marketed to consumers because it provides very low or no trailer fee to distributors
- Fund B is actively marketed by a large bank. Its inducements are most probably very high and most probably even higher than the disclosed total fund expenses.

Therefore, one can assume that fund B attracted many more future pensioners than Fund A.
See the dramatic consequences of this choice in the table and the lessons drawn below.
(to simplify , we showed the impact of one investment instead of repeated investments every year, but that does not change the conclusions).

1st lesson : investing early even in a retail packaged diversified equity product can lead to value destruction over the long term
Yes equity markets usually provide real value protection and even growth over the long term. Equities markets yes, not all packaged equity products by far.
In this real case, over 40 years, the EU saver who picked fund B is likely to have underperformed the comparable equity market and an other comparable investment product by more than 71 %.
Also, after tax he is likely to have lost money on a real basis (after inflation), even with a diversified 100% equity portfolio. Imagine what he would get with a bond product !

2nd lesson: starting to save early for retirement can give worse results than starting later, it all depends on the choice of the investment product to start with.
It heavily depends on the investment product selected, and odds are not in favor of savers as the marketed product is the one to avoid.
The investment product choice is much more important than the starting date of the retirement saving effort.
In this real case, <u>the EU citizen who started to save 40 years before retirement choosing fund B will likely get 22 % less income than the citizen who started 20 years after him but having found and chosen Fund A</u>.

3rd lesson: Product disclosure and information at the point of sale is too often grossly misleading, and the damage caused to the retirement saver is sky high.
The word “misleading” is used in its MiFID Directive sense.
In this real case, the fund B information at the point of sale (we have written proof) promises exactly the same thing as Fund A. Only in a section of the fund prospectus called “economy of the product” (not in the expenses section), one could read: “*in exchange of the dividends associated to the shares included in the index, the holder will get a net asset value based on*

Rue du Lombard 76
1000 Bruxelles - Belgium
www.euroinvestors.org
info@euroinvestors.org

the closing price of the index and no entry and exit fees for the subscriptions collected by the distributor". Even this quote that nobody probably read is itself inconsistent with the stated total expenses of 1.5 to 2.5 % when one knows that the recent average dividend yield of this index is above 3% anyway.
The very large inducement is not disclosed in the information at the point of sale, is not even identified as such and not even quantified in the product disclosures. Disclosures on costs are also misleading to say the least.

4th lesson: the lack of disclosure of net performance and of the performance of the comparable performance indicator is also too often very misleading
In this real case, the performance disclosure is not net of tax (as it is mandatory in the US). Also, the retail investor will not be aware that he is loosing money after inflation, because it is not disclosed anywhere.
Comparable indicator's performance is missing in the information at the point of sale. Even in the prospectus summary, it is impossible to learn if the index is comparable or not, i.e. if it is a "price"only index (without dividends reinvested), a "net return" index (with dividends net of a theoretical withholding tax) or a "global return" (with gross dividends) one. In most cases, these three have very different performance profiles. CESR has "advised" to use a comparable performance indicator whenever possible. This should be mandatory and more precisely and clearly spelled out.

5th lesson: it is very difficult to assess the long term performance of long term retail investment products for lack of publicly disclosed long term track records
In this real case (a typical one for that matter), the two products have a disclosed history of six years only. To assess their potential as long term investment products, we had to assume the same yearly average performance for future years as for the last 6 years. This is a big caveat in such analyses (e.g. over ten years – 2000 to 2009 it would have been even much worse because of the collapse of equity markets in 2001 and 2002). It is also potentially misleading as no one knows how they could have performed over the long term, which is the only term that matters for pension investments.

Rue du Lombard 76
1000 Bruxelles - Belgium
www.euroinvestors.org
info@euroinvestors.org

Two existing index UCITS funds replicating the French Big Cap equity index (CAC 40 index)

Ucits		**Fund A**	**Fund B**	**Loss**	**Inflation**	Cac 40 Index	Cac 40 Index
				Fund B / Fund A	Insee index	global return	Price return
Stated objective		"reproduce the evolution of the CAC 40 index"	"Exactly replicate the evolution of the CAC 40"				
Distribution		not promoted	Promoted and "advised"				
Performance	2004	11.37%	8.44%		2.11%	11.40%	7.40%
(net of fund fees)	2005	26.97%	24.69%		1.53%	26.60%	23.40%
(gross of entry and broker fees)	2006	18.95%	15.95%		1.53%	20.87%	17.53%
	2007	4.58%	1.70%		2.59%	4.16%	1.31%
	2008	-39.66%	-42.83%		1.00%	-40.33%	-42.68%
	2009	26.43%	22.32%		0.91%	27.58%	22.32%
End Value of Investment (for € 1 € invested)	6 years	1.3420	1.1150	-17%	1.1006	1.3516	1.1065
Cumulated perf. before tax	6 years	34.20%	11.50%	-66%	10.06%	35.16%	10.65%
Annualized perf. before tax		**5.02%**	**1.83%**	**-64%**	**1.61%**	**5.15%**	**1.70%**
Cumulated perf. after tax*	6 years	23.56%	7.92%	-46%	10.06%		
Annualized perf. after tax*		**3.59%**	**1.28%**	**-44%**	**1.61%**		
End Value of Investment	20 years	2.66559	1.43746	-46%			
(before tax, for € 1 invested))	30 years	4.35200	1.72343	-60%			
	40 years	7.10535	2.06628	-71%			
Disclosed max. fund fees		0.25%	2.50%**				
Disclosed actual 2009 fees		0.25%	2.31%				
Actual inducements		<0.25%	> to 3%				

* From 2011 on the French tax on capital gains is 31.1%, composed of 19% income tax and 12.1% social levies.

** 1.5% before 1 April 2009

© EuroInvestors, 2010