# European Pensions

www.europeanpensions.net | June 2013

## Anchors aweigh

How the UK is setting sail towards an improved pensions landscape

**FTT**

The controversy surrounding the proposed Financial Transaction Tax

**Cross-border pooling**

What should be considered before implementing cross-border asset pooling?

**Default funds**

The differing nature of European default funds and the lessons to be learnt

**Interest rate swaps**

Will regulatory changes reduce the popularity of interest rate swaps?

European Pensions

UK pension reform - Financial Transaction Tax - Ireland administration focus - Cross-border asset pooling - Dividend investing focus - Default funds - Interest rate swaps - Fixed income roundtable

June 2013

# No such thing as average

Peter Carvill explores the differing nature of default funds across Europe, and what countries can learn from each other


In April this year, the European Insurance and Occupational Pensions Authority (EIOPA) released *Survey of EU Practice on Default Investment Options*, a report that examines the depth and complexity of default fund administration across Europe.

EIOPA undertook compiling the report in order to identify how default funds across Europe are administered and to identify areas where best practice guidelines would be beneficial.

The importance of the default fund for its members, posits the report, is paramount: "The fact that the majority of plan members may well end up in the default fund means that the choice and design of the default (and any de-risking solutions contained in them) will be a crucial determinant of members' subsequent retirement income."

Ultimately, *Survey of EU Practice on Default Investment Options* recognises the difficulty of developing and applying best practice, stating: "The diversity of approaches in member states is understandable considering the diverse nature of provisions in both second pillar and across all three pillars. This makes it difficult to identify best practice in this area as it will depend on the nature of the pensions system in member states."

The diversity of approaches is underlined by the take-up of investment in default funds: just 8 per cent of second pillar pension holders in the Netherlands opt for a default fund, one-tenth that of the UK.

Mine a little deeper into the responses and the divergence emerge. The report finds a near-perfect split of 17 member states saying that default options were used on mandatory or voluntary bases, and 13 saying that default options were not used. There was a similar split on whether 'any aspect of the use or nature of the default fund was set by legislation' and saw 10 respondents saying 'yes' to 13 saying 'no'.

The number of investment options across Europe also shows a bewildering complexity: "The majority of respondents indicated that on average there are two to five investment options members can choose from. In Ireland there are on average 10 investment options to choose from and in Norway some providers offer six to 10 options. In the UK it is common practice that some providers offer up to 10 (and not rare to see funds providing up to 20) options, but this typically includes a default fund in addition to other investment options. In Sweden there are more than 800 funds to choose from."

The report brings out the sheer variety of fund structures across Europe. Looking at provision along the lines of the pillar system, Estonia, Latvia, Sweden, and Slovakia allowed those under its mandatory pension scheme to make investment choices, with those in Lithuania being able to make choices under their voluntary scheme. Under the second pillar, EIOPA identified four investment options – IORP, insurance (non-IORP), pension fund (non-IORP), and other occupational pension products. Here, IORP was the most popular, although most member states reported that members had a multiple choice from the others. The third pillar, which looked at personal pension policies, also showed a great sweep of choice, with member states reporting that pension holders could invest across insurance, investment management companies, pension funds, or IORPs providing personal pensions.

In summarising all this, EIOPA said: "We can conclude from this that multiple investment choices are widely offered to members in both occupational and personal pensions. However, for social security schemes, this possibility is not widespread."

Even among those countries that use default funds, the rationales split widely. In looking at this, EIOPA found an almost-equal spread across guarantee, conservative, lifecycle, and those specified by provider/employer/IORP.

All of these approaches have benefits and drawbacks. For default funds with guarantees, the rationale is to provide some level of protection for members. *The Role of Guarantees in Defined Contribution Pensions*, a 2011 paper from the OECD, said this about the investment strategy: "Defined contribution (DC) return guarantees can strengthen and complement the risk-reducing properties of lifecycle investment strategies, protecting retirement income against major investment losses. By enhancing people's appreciation of and confidence in DC pension arrangements, return guarantees can also boost the coverage of and contributions to these arrangements. However, as guarantees have to be paid for, they reduce the expected value of retirement income from DC plans."

With lifestyling, investments are linked to the age of the investor so when investors are young, their investments carry a higher risk. As they get older and prepare for retirement, their money is divested into safer, more risk-averse investments such as gilts.

Previnet's senior manager for pension fund services and international clients, Martino Braico, says that the lifestyling option is well-received among his clients. He adds: "They do like that from day one of getting a new job, they don't have to be worried about the pension scheme because something will happen without them being too involved. Of course, when you offer this solution, you also need to give members the option to opt out. That should be at least once per calendar year, or more frequently. Another thing we've noticed is that if an organisation is offering lifestyling options to members, they need to adjust their strategies to not include members with short-term contracts. Another point to keep in mind is that lifestyling can be very good for long-term jobs but may not be the best solution for those in the short term."

With conservative investing, default funds aim to limit risk to the stakeholder. But while that approach may protect the original investment, they are also likely to miss out on the greater returns potentially offered by riskier ventures.

But despite the complexity of fund investment across Europe, are there areas in which countries can learn from one another? Yes, says Cardano Risk Management's head of innovation Stefan Lundbergh. He says: "Countries can learn from each other in most cases. If you look around Europe, there is no place that is perfect. What Europe can learn from the UK is a lot of the design behind auto-enrolment and that in work-choice. They have done a lot of work there. I think a really important piece of the design is that you start by saving a few per cent, then it goes up to a few more, then a few more the next year. It becomes easy to come into auto-enrolment and we increase it every year in contribution weight. And that's a very smart design of the default and of the enrolment in general. A lot of European countries can learn from what the UK has done in designing this, because it was a big step forward for the UK."

Braico acknowledges the difficulty in coming up with a one-size-fits-all best practice across Europe. He says: "I think pension funds and supervisors should support a best practice approach. Guidelines and documents are very well welcomed in Europe. It's not easy to find a single best approach over Europe because investors in, say, Italy are not the same as investors in Britain. In Italy, they tend to be more conservative while in the northern countries there is a little more acuity when making decisions. So there's no perfect decision across Europe. Guidelines can be given but not a single decision – each country has to fine-tune any indications given by someone such as EIOPA."

Cardano's UK client director Phil Page says that any pan-European best practice guidelines would be akin to getting a ship to change direction. "It's not an agile speedboat that can change directly, it's a massive liner," he says. "If you look at the UK where there's been the recent introduction of auto-enrolment, there was a massive effort in marketing and communication to get people to understand what it is. To come in with any alternative to that in the next few years will probably just confuse people and might be counter-productive. So much communication is needed because of all the legislation and people involved that it's a very, very slow process."

WRITTEN BY PETER CARVILL, A FREELANCE JOURNALIST