association of the luxembourg fund industry

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EUROPEAN COMMISSION
Directorate General
Health and Consumers
To: SANCO-THIRD-PILLAR-PENSION-FUNDS@ec.europa.eu

Luxembourg, 19.07.2013

RE: response to the COMMISSION STAFF WORKING DOCUMENT on "Consumer protection in third-pillar retirement products"

Dear Sirs,

We, the Association of the Luxembourg Fund Industry (ALFI), are the representative body of the 2.6 trillion Euro Luxembourg fund industry, as at 31 May 2013. We count among our members not only investment funds but also a large variety of service providers of the financial sector. There are a total of 3,884 undertakings for collective investment in Luxembourg, of which 2,497 are multiple compartment structures containing 12,194 compartments. With the 1,387 single compartment UCIs, there are a total of 13,581 active compartments or sub-funds based in Luxembourg.

ALFI has a specialised working group focussed on pension funds and long-term savings, which is active in respect of third-pillar retirement products. Therefore, we very much appreciate the opportunity given by your Commission to contribute to the reflexions on third-pillar products and in particular on consumer protection aspects in this context. ALFI agrees that consumer protection is of highest importance for such products, where a product shall be offered to consumers which will have a long to very long time horizon and which will have limited to no liquidity.

ALFI firmly believes that it is essential to ensure that consumers are aware of the characteristics of such product and subscribe to it on a fully informed basis, so as to avoid any misunderstandings and bad surprises which could affect the credibility of such product.

It appears to us that in order to create a suitable background for the success of a third-pillar product, consumers should ideally understand the economic situation where first pillar retirement guarantees may be or become insufficient to cover the needs of retired persons, which should create an incentive for consumers to subscribe to individual retirement products.

As results from our answers on the specific questions below, we would like to underline our conviction that better informing and educating the investor will be absolutely key to achieve successful third-pillar retirement products.

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Q1. *Is the following definition, used in the 2012 questionnaire, effective for identifying third-pillar retirement products? "Third-pillar retirement products are defined as any type of private retirement product subscribed to by consumers on an individual basis [as opposed to occupational], either voluntary or mandatory"*

We suggest that the explicit reference to the exclusion of occupational plans in that form is removed, because there are cases in which products may combine certain elements of occupational plans and private plans and it may not be clear from the outset which legislation applies or indeed which legislation should apply. We suggest therefore that the definition be amended slightly (see below).

Q2. *If not, what would be the most appropriate common EU definition for third-pillar retirement products.*

“Third-pillar retirement products are defined as any type of private retirement product subscribed to by consumers on an individual basis either voluntary or mandatory, <u>which are not covered by legislation applicable to occupational pension plans</u>”.

Q3. *What are the main risks for consumers when purchasing a third-pillar retirement product?*

The main features of traditional retirement products are that the investment risk falls onto the individual (consumer) during the accumulation phase and potentially during the pay-out phase. This can lead to individuals being left with insufficient income during retirement and difficulties for individuals in planning their retirement.

Against this background ALFI believes that there is room for creating a workable third-pillar pension product to cover the additional needs of retirees. As an overview, some of the main issues for consumers when purchasing a pension product are:

- Misunderstanding of the pension product’s underlying risks (market risk, inflation risk, counterparty risk, etc.) due to the complexity of the product and the financial environment;
- Lack of a standardized description of the product features (loading, risk, benefit, etc.);
- Inconsistency between the risk profile of the investor and the effective investment strategy;
- Liquidity issues due to lock-up periods, in particular in case of unforeseen events (unemployment, disability…);
- Unstable performance/risk measures of the underlying assets from a long-term perspective (from 25 years to 40 years);
- Higher charges in comparison with the modest periodic investments due to distribution cost generated by such products;
- Unstable fiscal environment in a long-term perspective that may reduce the product attractiveness;
- The distribution of pension products were appropriate distributors and advisors may be lacking in certain parts of the European territory;
- Returns may fall below the expectations of the investor as well as the simulations that were conducted at the time of the initial contracting for the product;
- Transparency and comparability between different products and different product providers especially during the decision making process in order to make an adequate decision based on sufficient information;
- Information whether the product allows any withdrawals or the chance of the provider during the accumulation phase.

ALFI therefore strongly believes that clear warnings should therefore be included in any type of individual pension product highlighting to the consumer that there are clear risks in the event that money needs to be accessed prior to maturity.

Indeed, as stated in the introduction above, we see considerable risks resulting from certain investors' limited information and education. There are considerable risks of mis-selling as investors do not necessarily understand the products in which they invest. They are rarely financially educated. This is valid even more as far as long-term, illiquid retirement products are concerned. Investors should be aware that a third-pillar vehicle may allow them to complement their pension, however one should avoid unrealistic expectations of their pension when they invest too little money and they start their investment at a late stage of their life.

In addition, as stated above, investors should be fully and clearly informed on the lock-up rules applicable to this type of product, as well as on any penalty in relation to partial redemptions of the assets (if possible under the applicable regime) which should also be very clear to investors before they invest or on features that provide flexibility, e.g. the chance of withdrawals or the change of the provider during the accumulation phase.

Finally, it would appear to us that investors should be fully aware and informed on the fees charged when they subscribe to this type of product and the on-going charges and expenses (including tax) that they will be subject to.

The sale of such products should be clearly regulated so as to avoid the wrong incentive leading distributors to sell the wrong product to the wrong investor. The investors should be clearly informed on the expectations they could have in different scenarios including in very extreme scenarios.

Pension solutions need a suitable investment allocation depending on the nature of the investors and also require a regular review over time which requires initial but also on-going information and potentially advice to investors (although this may be difficult to implement).

Q4. *How problematic do you consider the asymmetry between the consumer and the provider in terms of information about and knowledge of third-pillar retirement products?*

This question is closely linked to question 3. We agree that the asymmetry of information is a challenging topic that has potential for creating difficulties. As stated before, consumer education and awareness of the purpose and on the features of third-pillar products seem to us one of the fundamental issues to tackle in order to make such products fly. In ALFI’s views raising the awareness and understanding of the large population is a precondition to the present initiative.

Besides the need for a general understanding by consumer which is necessary to create a general acceptance of third-pillar products, we see a risk of misselling of third-pillar products, which could potentially create serious issues. It should in our view be considered to create appropriate safeguards to avoid that incentives might drive distributors to sell the wrong products to the wrong consumers. Due to the foreseeable lack of funding in first pillar pensions assets there is an increasing need for consumers to look into individual pension solutions. As a result of such need combined with the lack of experience with financial products, consumers may be vulnerable and dependent on information provided by the product offeror. Such asymmetry may create disadvantages for the consumer in the sales process.

In ALFI’s views it is crucial that the marketing of third-pillar products should be subject to sufficient safeguards that ensure that despite an asymmetry of information consumers receive adequate information on the product they are buying. As part of such safeguards (without limitation though) it is certainly necessary to ensure that persons selling third-pillar products have an adequate qualification to advise on suitable products, structures and investment choices. Additionally, in ALFI´s view transparency and comparability between different products and different product providers are of utmost importance especially during the decision making process in order to make an adequate decision based on sufficient information.

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Q5. *Are there specific needs of consumers purchasing third-pillar retirement products that have to be better taken into account, for example via EU voluntary codes or certification schemes on consumer information (transparency) and protection standards?*

- *If so, how could consumer information (transparency) be improved? Please cover precontractual and contractual information*
- *If so, how could protection standards be improved? Please cover marketing, sales practices, inducements, advice and other aspects.*

An EU voluntary code does not seem to be adequate to ensure adequate protection regarding such important consumer information and protection standards in pension solutions, which are subject to very long lock-up periods and potential penalties in case of early redemption. Please refer to our answers to questions 6,7,8 and 9 below.

We believe one important factor would be the creation of a "PRIPs like" information document which would however need to be specifically designed for personal pension products, with adequate information and comparability features. Such document should ideally also provide investors with a projection so that investors can anticipate what could happen in different market scenarios after 5, 10 or 20 years. One will have to precisely consider the characteristics of the product for the purposes of such information document.

As issue we see is however the discrepancy of sales regulation in different segments of the industry. In fact, depending on whether a pension solution falls within the insurance regulation or the asset management regulation, the rules are not the same. We believe that MiFID and IMD rules will need to be aligned in respect of this type of product to ensure that consumer get a reliable, comparable picture of the product they are buying. In this same context, we believe that it is necessary to closely consider the requirements on adequate advice to the consumer ahead of selling third-pillar retirement solutions.

Q6. *Would a self-regulatory code be the best tool for improving the quality of third-pillar retirement products?*

See answers to Q 6-8 together under 8 below

Q7. *For which objectives would it be the best way of doing so? (e.g. improving consumer confidence, providing a guarantee of quality, or others).*

See answers to Q 6-8 together under 8 below

Q8. *What outstanding pension-specific consumer protection issues could a self-regulatory approach help to deal with?*

ALFI believes that self-regulatory codes can be efficient in certain instances. However, taking into account the importance of retirement products for investors and their need to invest in (relatively) safe and suitable products with a high level of protection, the use of more effective tools (like EU legislation) may be preferable. In addition to the above, ALFI is also wondering whether self-regulation on a pan-European basis is actually realistic, where usually self-regulation is applied rather within a limited territory having a coherent legal, cultural framework. The geographical spread of the European territory and the diversity of regions, legal contexts and cultures could in our view create another practical barrier to a harmonisation of EU products via self-regulation.

Q9. *How and by whom should the effective application of the code be monitored?*

One of the reasons why we do not agree with a self-regulatory approach is that it is not clear how this self-regulation could be monitored by public authorities.

Q10. *Would an EU certification scheme be the best way of improving consumer protection for third-pillar retirement products?*

In ALFI's views, retirement solutions for the European consumers are crucial and need an adequate and reliable level of protection, which should be the same in all European Member States. Pension products must be subject to specific transparency regulations harmonised at EU level. The scheme should mean "EU transparency certification".

Additionally, before answering this question it appears necessary to define what "EU certification" should mean. In fact, it appears that such term could be understood as two different mecanisms:

(i) either a UCITS-type European label based on a binding harmonised European legislation,

(ii) or a non-binding certification which is based on certain quality criteria but which does not imply a harmonisation of the product itself.

If one understands certification as meaning a non-binding certification of products or services to document their compliance with certain basic requirements, we see three aspects of this approach which are problematic.

Firstly, the determination of relevant requirements to obtain certification pre-supposes that the requirements for products and services are split between the essential requirements that must be fulfilled to "certify" certain products, and other (only) desirable attributes, which in turn need not be fulfilled as a standard to obtain certification. We are afraid the identification and EU-wide agreement on the relevant "essential" requirements (and the relating impact) will be difficult to achieve.

Secondly, if certification is non-binding, we are afraid that its value may be limited and fall short of the ambitions of the European third-pillar initiatives. We are wondering whether a fully harmonised set of requirements, similar to the UCITS requirements, and the obligation for mutual recognition by member states, might not be a more coherent approach.

Thirdly, it seems to us that one should cautiously bear in mind that the introduction of a further layer of requirements for certification in addition to local and EU-requirements for authorisation and other current regulatory initiatives is likely to add to the cost and complexity of products and services.

ALFI strongly supports the idea of a UCITS type label with harmonization of legislation.

Q11. *For which objectives would it be the best way of doing so? (e.g. improving consumer confidence, providing a guarantee of quality, or others?)*

n/a (given answer to question 10 above)

Q12. *What outstanding pension-specific consumer protection issues could an EU certification scheme help deal with?*

One important area where certification may improve consumer protection is consumer education, where a common brand for third-pillar products can promote investment education which as stated in the introduction seems to us as being one key factor of success. Making reference to the answer in questions 6-8 above, please note that we believe that self-regulation is unlikely to achieve the same success, which an EU certification scheme may be able to provide.