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Report on Investment options for occupational DC scheme members

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Executive Summary

Following on previous EIOPA work on investment default options, decumulation practices and information provision, this report aims to **map out the available choices that members of occupational DC pension schemes have in the European context regarding investment in their retirement plans**. Having developed an overall picture, the report highlights the main issues that national supervisors strive to address in order to **ensure the making of effective investment decisions**. Effective investment decisions are decisions made in the interest of members, working towards ensuring a sustainable level of pension income. Thus, examples of practices that can become inspiration to national authorities have been outlined.

About two thirds of EU/EEA Member States took part in the data collection exercise (21 out of 28, see the Appendix (B) for a detailed list), the rest of the member states deciding not to participate, or not being able to contribute since they do not have/permit occupational DC pension schemes operating within their jurisdiction (Germany, Denmark¹). However, when interpreting the replies from Belgium one should bear in mind that there are no pure DC schemes operating in Belgium, since occupational DC schemes are subject to a legal minimum guaranteed return².

The general layout of the report and its findings were structured on the ground of traditional financial investment theory, but have mostly taken account of specific behavioural aspects that have been theoretically proven to be manifested by individual members (see the Appendix (C) for a list of bibliographical references). It is important to note, however, that in most cases, due to practical reasons of implementing investment options and cost-benefit analyses, members of occupational DC pension schemes are treated as a target group and investment strategies are built at an overall level.

In most of the member states, occupational DC pension scheme members do not have the ability to make investment choices or have a limited ability to do so (a limited set of choices). One reason, supported by behavioural finance theory, relates to members having a limited rational capacity of making investment decisions in their own interest, which are often biased by contextual factors. In most of the Member States where investment choices are available for members, a default investment option is also available to help individuals deal with initial and on-going decisions they would otherwise have to make. As a result, **members' "investment decisions" in this report generally refer to the selection of options** (*when choice is available*). This is because in most cases, **investment strategy decisions are made on behalf of members** by other entities from the pension systems.

In occupational DC pension schemes, **the most important entity in developing the investment strategy is the IORP. However, in most cases the employer is also involved in the determination of the default investment option**. As a result, the question of the employer role and influence in occupational DC pension schemes deserve further considerations. Nevertheless, **the main focus of entities involved in developing investment options**, especially when members have no choices or are part of the default, **is the suitability of the strategy with target groups' risk and return characteristics**. Although automated decision tools and personal

¹ In Denmark there are no operating IORPS offering DC schemes.

² 3.25% on employer contributions; 3.75% on employee contributions and 0% in case of self-employed workers.

assistance exist in a few Member States that do offer choices to occupational DC pension scheme members, **much of the efforts is put in general information provision**, a method that has been previously proven not to be a panacea.

The analysis of the information provided by Member States has shed light to the following issues in occupational DC pension schemes, which EIOPA may consider moving forward and may also require further attention from policy makers:

- better mechanisms and methods of improving **suitability of investment options compared to target members' risk and return characteristics**;
- methods of **supporting third parties** (*e.g. employers*) who make or frame investment decisions on behalf of members, **where relevant**;
- **improved mechanisms for providing relevant standardised and comparable information** to help members making better investment decisions, in case they have to make such decisions.

1. Introduction

Pension systems across the EU are facing numerous challenges to deliver on their promises (*e.g. longevity risk, budget deficits, and low interest rates*). Creating sustainable and adequate retirement income for EU citizens will therefore entail the further development of private complementary pension savings and the need to regain their trust and confidence in private pensions. In the context of Defined Contribution (DC) occupational pension schemes, a European regulatory framework supporting these objectives means, for instance, that members need to understand the risks they are facing (*e.g. investment risk*) in order to make appropriate investment decisions whilst supervisory authorities need to ensure that pension schemes are properly governed, and act in the best and sole interest of members whilst investing prudently on their behalf.

Previous EIOPA work on good practices of information provision for DC schemes (EIOPA, 2013) showed the importance of considering insights from behavioural research. The report highlighted that when provided with a high level of choice and faced with complexity or uncertainty the average pension scheme member tends to make suboptimal decisions which are based on fast information processing and influenced by various heuristics and biases (Kahneman, 2012).

Given these behavioural biases, Institutions of Occupational Retirement Provisions (IORPs) and employers usually play an important role in supporting members in occupational DC schemes to make effective investment decisions³. As professionals with the fiduciary duty to act in the best interest of members and invest prudently, IORPs commonly take over at least part of these decisions with regard to the details of the investment strategy. They also decide on the way in which choices are offered and presented to occupational DC scheme members.

Where IORPs offer a simplified set of investment choices, for instance by allowing scheme members to choose between a few options with a higher or lower level of risk, behavioural issues also need to be taken into account. For example, if prompted to make active investment decisions, Max⁴ may be easily “swayed” by the way investment questions are presented or “framed” to him. Equally, if Max is not prompted to make active choices, he will typically take the path of least resistance and stay in the defaults irrespective of the suitability of the latter (Mitchell & Utkus, 2003).

In light of the above, EIOPA initiated a project seeking to:

- increase the understanding of behavioural issues in the context of members’ investment decision-making in occupational DC schemes;
- identify different ways in which effective investment decisions can be facilitated, including the role IORPs, employers, various other professional entities, policymakers, European and national supervisors play to support the latter;
- map out across the EU/EEA Member States (MS⁵) that took part in the exercise 1) the extent to which occupational DC scheme members are offered investment choices; 2) the degree to which occupational DC schemes members

³ In the context of this report, ‘effective’ investment decisions refers to investment decisions in the interest of scheme members.

⁴ More detail on ‘Max’ can be found in EIOPA’s report on good practices on information provision for DC schemes (EIOPA, 2013).

⁵ Please refer to the Appendix (B) for a list of Member States.

receive the support of IORPs, employers or other professional entities throughout Europe; and 3) ways in which supervisors and policymakers aim to support better decision-making in occupational DC schemes and address potential risks that are identified by the authorities;

- draw conclusions about different effective methods of support given the peculiarities of members' decision-making.

This report focuses on occupational DC schemes, predominantly under the scope of the IORP Directive⁶. The information provided by the supervisors that took part in the mapping exercise was collated on a "best effort" basis. The findings and conclusions of the report are confined to the structure of the mapping exercise and the interpretation of MS and MS responses alike. In the context of this report, Max may most often refer to a collective or target group of individuals. It is worth noting that the mapping exercise reflects the situation described by MS as of **1st of September 2014**.

As a project initiated within the Occupational Pension Committee's (OPC) mandate, this report is aimed at national supervisors, European and national policymakers and experts with an interest in the field. The report also builds on earlier EIOPA work on EU practice on default investment options (EIOPA, 2013) and complements EIOPA's fact finding report on decumulation practices (EIOPA 2014).

The report is structured as follows:

- **Chapter 2 first sets out the general theoretical framework** underpinning optimal investment decisions. It then describes latest insights from the behavioural research literature relevant to understanding members' decision-making process, and which legal and supervisory frameworks should be taken into account to ensure investment decisions are designed in the best interest of pension scheme members. Finally, the chapter outlines the theoretical baseline of choice architecture available to members in the European context, which was used to design the mapping exercise questionnaire;
- **Chapter 3 maps out the types of choices members, IORPs or other entities make in the context of occupational DC schemes** across the 21 MS who took part in the survey;
- **Chapter 4 highlights the risks** identified by supervisory authorities in addition to the legal and supervisory approaches considered to best mitigate these risks;
- **Chapter 5 provides conclusions and highlights potential areas of work for future consideration.** It is important to note that the report's conclusions are based on theoretical and practical insights and the interpretation of MS' answers to the survey conducted amongst national supervisors. The survey was executed on a "best effort basis" and subject to additional clarifications.

6 Some exceptions and observations brought forward by national authorities, as follows:

- National supervisors of **RO** and **NO** have filled out the questionnaire for DC schemes not under the scope of the IORP Directive. In **RO** there are no formal IORPs but individual pension funds operating under IORP directive as informal reference by national legislation. In this paper personal pension funds are regarded as provider that falls under IORP directive.
- In **SE**'s case, information has been provided exclusively for IORP establishments.
- In **Denmark (DK)** there are no IORPs offering investment choices and all operating IORPs offer DB schemes. Investment choices are more common in life insurance undertakings and multi-employer pension funds. However, such undertakings are not regulated based on IORP and therefore **DK** did not cover investment choices in schemes offered by such undertakings.
- **DE** did not take part in the survey because DC schemes are not permitted in this MS.
- In **HU** there is only one IORP with a low number of members, however the supervisor has sent a complete set of information for the current report.

2. A theoretical framework for developing the investment strategy

This chapter first explores three theoretical steps performed in the investment process that should be followed to make an investment decision in the interest of an individual member. It then sets out a variety of ways the investment decisions might be presented and offered to members in the context of occupational DC pension schemes.

The chapter describes the three step theoretical approach, which is used as a framework to assess whether different ways of organising investment decisions are in the interest of the member. Building on the latter, the analysis incorporates the extent to which members might be more or less involved in these steps. In the field of occupational DC pensions often the investment decision is made in the interest of a collective. This might often be a highly cost-efficient way to save for retirement, while there is a trade-off with the suitability of the investment strategy. Members in different schemes may be more or less directly involved in the different stages of the decision making process.

2.1. Theoretical steps of the investment decision process⁷

2.1.1. Constructing the Investment Policy Statement (IPS)

In theory, in investment management, the IPS would represent the set of guidelines and requirements on which the entire investment process would be based. The IPS would be constructed on the grounds of specific objectives, characteristics, desires and specifications of each member or, more often, of the group of members it would apply to. The IPS should be periodically revised.

When structuring the IPS, there would be some general steps that could be taken in account.

1. Building the Return Objective

This first step would imply the understanding of how much return members would require from their retirement portfolio so as to meet their primary goals (*living expenses, maintaining a standard of life and/or passing on part of their assets*), or at least part of them, if taking in account other sources of wealth during the retirement stage. When considering meeting goals, it would be useful to assume a total return approach (*other sources of income, including other pensions – pillars I, Ibis⁸, and III*). The return would be regarded in net terms, after costs and after tax (*given specific tax legislation in each MS*).

2. Building the Risk Objective – risk ability vs. risk willingness of members;

In order to determine the risk ability of members, the following factors might be considered:

⁷ The general outline and terminology used in Chapter 2 is based on study materials from the CFA Institute (2014); among other, this includes the Investment Policy Statement, the Strategic Asset Allocation, and the Risk and Return Objectives.

⁸ Most of the new EU MS have developed a pension's model which includes among other things a mandatory pension pillar referred to as "1st pillar bis" and that have been established by a so called carve-out approach, by dividing the former state pension contribution between the first PAYG pillar and the new 1st pillar bis. Employees' contributions are collected by the employer and/or by the social security network and directed to personal accounts managed by private financial institutions chosen by the employees. In some of these MS employees' contributions are transferred to pension schemes/institutions by employers. The relations between pension institution and employee are based on a contract.

- **The time horizon** – the time left to recover from unsuccessful investments and the time left to build wealth for meeting goals – expected accumulation and decumulation periods;
- **Liquidity needs** – these needs would be shaped based on expenditures expectations that members would have regarding the decumulation phase. Given these expectations portfolio structure might require adjustments closer to retirement;
- **Importance of goals** – the more prominent/imminent would be the primary/critical goals that the pension income would be destined to address, the less risk members would be able to take;
- **Other financial resources** – this factor would count for other resources that members might possess to meet goals (*for example other pensions*);
- **Legal and regulatory constraints/specifications** – restrictions for certain investments, and for wealth transfers, affecting both return and risk objectives.

Risk willingness (*also known as risk appetite*) would be a complex matter to assess, being deeply rooted in the psychological layers of members (*including their perception of future needs and ways to meet these needs*) and reflecting the general risk aversion of each member in its turn. Risk willingness might often be determined from cues given by a member's personal context and direct answers that they might offer in questionnaires or interviews. The questionnaire would often be the accessible method. However, it would have its limitations, mainly based on the framing and clarity of questions (Linciano and Soccorso, 2012⁹).

2.1.2. The Asset Allocation (AA)

In theory, the AA would imply constructing the actual asset composition of the retirement portfolio, primarily within the confines of the IPS (*for example, regarding the risk objective, fixed income securities have generally less risk than equity and other alternative investments; derivatives can be used to further hedge investment risk*). When building the AA decision-makers would also consider the long term capital market expectations and their possible effects on potential asset classes (*these expectations are revised periodically*).

Portfolio parameters would be periodically monitored and rebalancing would be done if and when the portfolio structure would deviate significantly from the AA or the IPS specifications. Rebalancing would have the aim of adjusting the structure back to its original parameters, depending on cost-benefit analysis.

In order to meet the return and risk objectives of occupational DC scheme members, an optimal level of diversification would need to be taken in account. The main role of diversification would be to eliminate unsystematic risk¹⁰ (*also known as specific risk or diversifiable risk*) by not exposing too much of the portfolio to the specific risk of one company, one industry or one sector. Diversification would take into account the correlation between asset classes and individual securities and would aim at reducing risk with no or as little as possible negative impact on the return.

9 Linciano and Soccorso bring forward some specific points to assessing the risk tolerance of members through a questionnaire. Some of these particular points are: socio-demographic characteristic of members, experience and knowledge, financial situations, and their main objectives.

10 Unsystematic risk, is the specific risk of a particular investment, a risk that can be diversified away through the composition of portfolio. On the other hand, systematic risk is the overall market risk that cannot be eliminated through diversification and it is the risk for which the investor is rewarded through return.

2.1.3. Evaluating Portfolio Performance – feedback and control mechanism

As the final theoretical step, after the portfolio would have been constructed, periodically the performance of the investment choices should be reviewed and adjusted, based on the feedback received from the portfolio performance and changes of market conditions. This would imply the measurement of portfolio performance, and the comparison with a set benchmark. Subsequently, decision-makers determine whether performance could be attributed to decision making, to overall market movement or simply to chance. It should also be determined if the policy implemented (the IPS) was successful (or in what terms it was not), identifying qualitatively areas of value gained and value lost, and providing feedback on consistent application of this policy. Based on this evaluation, the IPS might be revised.

2.2. An average DC scheme member, such as Max, tends to make suboptimal investment decisions

In order to achieve an optimal investment strategy in their self-interest, members of occupational DC schemes need considerable financial investment skills, time and motivation. EIOPA's previous work on good practices of information provision (EIOPA, 2013) introduced Max, the average pension scheme member who typically lacks the skills, the time and the motivation. Max relies on rules-of-thumb instead, and consequently makes systematic errors.

EIOPA's report (2013) on Good practices on information provision for DC schemes introduced 'Max', an average European DC scheme member to understand a new approach to information provision.

It is known that Max behaves differently than the often assumed 'Homo Economicus' (Tiemeijer et al., 2009). By definition people have limited time and motivation to read and understand pension information (Sunstein, 2011). Whereas it is assumed that information leads to understanding, to the willingness to act and subsequently to appropriate actions, this appears most often not the case. Max has scarce processing resources and cannot consciously read and analyse all the information that he encounters (Kahneman, 2012).



Insights from behavioural research suggest that when provided with a high level of choice and faced with complexity or uncertainty, Max tends to make suboptimal decisions. Where an individual like Max invests for retirement he exhibits behavioural biases, having the tendency to: *under-diversify, over-invest in 'familiar' stocks (e.g. stocks of the company he works for), tends to sell and/or purchase at wrong moments* due to different experiences of losses and gains, *bases his decisions too much on past performance, gets overconfident, and trades too much* which, due to associated costs, goes at the expense of rewards (Mitchell and Utkus, 2003).

It is worth noting that in the context of the investment process in pensions in this report, Max most often takes the shape of a collective or target group of individuals.

2.3. A theoretical behavioural analysis: What are common causes of suboptimal investment decisions?

As mentioned before, when faced with making investment decisions members are prone to making different types of mistakes. For instance, they may be putting too much weight on past performance and on the most recent events. Recent research from NEST (2014) showed that people under-emphasise long-term historic performance trends and overemphasise recent issues in investment performance. The recent global financial downturn suggests that anything can happen in pensions. The research concluded that people are more likely to accept the inherent uncertainty of investment returns if one can help them not to overemphasise the improbable. One way could be to communicate that the investment strategy seeks to protect members' money while growing it. This would implicitly help deal with the notion of risk.

Common causes for suboptimal decision-making can be found in aspects explained by behavioural finance. As previously stated members are not a good representative of the so called "Homo Economicus" and cannot fully understand and apply, in most cases, the principles of traditional finance (*bounded rationality*) where they would: be able to fully identify their goals and needs, fully assess their resources and capabilities, and determine a good prognosis of financial and human capital in order for them to make the optimal financial decisions. As such, members strive to make decisions based on heuristics applied to the contextual background and they strive to achieve satisfaction and not an optimal state. The following section provides some insight into common cognitive and emotional biases that members manifest in making investment decisions.

2.3.1. Inertia or status quo

This is an emotional bias that individuals manifest based on the strong desire to do nothing if such a possibility is offered to them or if they are confronted with a passive choice (only the possibility to opt out). This bias leads to the possibility of sticking with an investment choice that is inappropriate to the objectives and constraints, to the particular profile of a member.

Madrian and Shea (2001) analysed automatic enrolment and showed that the benefit of higher plan participation rates appeared to be offset by a profound level of inertia. Most participants remained at the default savings and conservative investment choices set for them by their employer. Once enrolled, participants made few active changes to the contribution rates or investment mixes selected for them by their employer; rather, they simply stayed with what was assigned to them. The default option becomes the de facto selection even if it is not the optimal choice¹¹.

11 Beshears et al. (2008)

2.3.2. Representativeness and availability heuristics

When faced with complexity, risk and/or incomplete information, individuals use simple rules of thumb or mental shortcuts, so called heuristics, leading them to make inaccurate estimations and hence sub-optimal decisions. Behavioural research refers to the concepts of “availability heuristic” and “representativeness heuristic”¹², to respectively show that in face of complex decision-making, people will rely on readily available information and attempt to impose some order or structure on the information that they see. In the context of making investment decisions, this means that Max will tend to rely on past fund performance and fail to take expected returns as well as risk into account.

2.3.3. Choice and attribute overload

In a direct connection to the behavioural aspect of inertia, individuals tend to be discouraged in making investment decisions if they are confronted with too many options or attributes of a number of options¹³. As such, the effort of comparing and assessing a too large number of factors encourages members to “do nothing”, this potentially leading to sticking to a decision that is suboptimal (*the default option becoming the de facto selection even if it is not the optimal choice*¹⁴) or simply not taking any decisions concerning retirement. In this situation two factors need to be balanced out: more options increase the chances to find a suitable match but more options also increase the cognitive burden of needing to evaluate them¹⁵.

2.3.4. The influence of information framing

Framing is an information processing cognitive bias that individuals manifest, and it refers to the direct connection between the manner that information and choices are framed and the way that the information is processed and consequently, the decision or answer that individuals will form in a particular context. This processing bias may have negative effects when assessing the risk characteristics of members’ decisions compared to their own particular profile.

A decision is thus influenced by the phrasing or frame in which the problem is presented¹⁶. Much of the research in this area has investigated the impact of investment menu design on participant investment choices in defined contribution retirement plans. The theme underlying this research is that menu design is a more powerful influence on participant decision-making than the underlying risk and return characteristics of the investments being offered. The negative consequence for Max here is that he therefore is not able to always make a correct estimation of the risks he is taking.

A classic example of decision framing arises with automatic enrolment in retirement saving plans. Under the traditional (*non-automatic*) approach, the employee would have to make a “positive election” to join a pension plan. By contrast, with automatic enrolment, the employee would be signed up by the employer for the plan at a given percentage contribution rate, and the employee retains the right to opt out of this decision.

12 Tversky & Kahneman (1974)

13 Sethi-Iyengar et al. (2004)

14 Beshears et al. (2008)

15 Johnson & al (2012)

16 An & Shi (2012)

The impact of automatic enrolment is not just an illustration of framing questions but also part of a broader behavioural phenomenon, namely the power of the "default option" and its influence on decision-making. When confronted with difficult decisions, individuals tend to adopt heuristics (*shortcuts*) that simplify the complex problems they face¹⁷. One simple heuristic is to accept the available default option, rather than making an active choice. An emerging literature indicates that individual behaviour is easily swayed by default choices¹⁸.

Another contributing factor is the fact that Max usually lacks firm preferences, such that investment decisions are made on the spot, given a contextual framework. As such, the menu design may have a more powerful effect on him. A common approach to this framing effect is "avoid extremes, choose the middle" heuristic, and there is no real effort of arranging the offered options in a well ordered risk-reward preference (Mitchell & Utkus, 2003).

Framing effects can affect members' investment decisions in several ways. Research from Iyengar et al (2003) shows that offering a long list of investment options where employees are given 50 or 100 choices of funds is confusing and de-motivating for some and concludes that group choices should be no more than 5 to 9 categories. Consequently, presenting tiered investment choices and/or a limited menu of core options (*with additional choices for more sophisticated individuals*) may be more effective in engaging Max.

Other research indicates that careful considerations on how to present and frame information may aid Max with his investment decisions. For instance, in the context of fund choices, schemes should consider using meaningful labelling to categorise funds e.g. use "funds for high flyers" and "funds for people who want to be safe" in place of "high risk" and "low risk" funds. Other research also suggested the use of pictorial representations to help people's understanding by appealing to the intuitive/affective system not or help them decide their willingness to take a risk (Botti and Iyengar, 2006; Lipkus & Holland, 1999).

Benartzi and Thaler (2001) also showed that even when given a choice between holding their own portfolio, the portfolio of a median member of their pension scheme, or the portfolio of the average scheme member, employees found that portfolios constructed at the statistical average of their co-workers' behaviour more attractive than the portfolios they themselves constructed. About 8 out of 10 participants showed preferences for the median to their own portfolio, with many finding the average portfolio to be satisfactory.

2.3.5. Loss and ambiguity aversion

Individuals tend to be more concerned with their possible or actual change in wealth, rather than their actual level in wealth. Moreover, behavioural finance research¹⁹ suggests that losses relative to a reference point are disliked about twice as much as equal-sized gains, suggesting that it is easier for individuals to forego a gain than accept a loss²⁰.

17 Thaler & Sunstein (2003)

18 Choi et al. (2001)

19 Kahneman & Tversky (1984)

20 Odean (1998)

In practice, this means that Max may put more effort into preventing a loss than winning a gain, and base his investment decisions on a short-term rather long-term horizon in light of volatility. On the other hand, when assessing a situation from the perspective of a potential loss, "loss framing" will occur. In such situation, of a losing streak, Max may have trouble "cutting his losses" and therefore take greater risks (e.g. by holding onto his loss-making stocks for too long) in the hope of recovering his losses and achieving his target²¹.

Ambiguity aversion links to the desire to avoid unclear circumstances, even when this will lead to suboptimal decisions²². This leads to inappropriate decisions compared to the risk profile of the member itself. For example Max may tend to like guarantees, even if they may come at a high cost.

2.3.6. Naïve diversification

Naïve diversification is a good example of bounded rationality, suggesting that people have "naïve" notions about diversification and will, for example, follow the "1/n strategy": dividing their contributions evenly across the funds offered in the plan, with no actual assessment of the impact that the strategy has on the risk and return characteristics of their overall portfolio. When this strategy is used, the assets allocation depends directly on the make-up of the funds offered in the plan²³.

2.3.7. Lack of monitoring and reviewing

One general result of the cumulus of behavioural aspects described above is the lack of monitoring and review of the asset structure of the retirement resources in comparison to changing circumstances of the markets and risk and return profiles of members. Evaluating entails considering an additional decision or changing a previous made decision. In such cases members may succumb to inertia and status quo. Additional decisions also provide a path to an uncertainty. In such a case ambiguity avoidance can prevent Max from evaluating previous decisions for it requires him to engage in uncertainty again.

2.4. Supporting Max by the "choice architecture"

Traditionally, legal requirements and supervision in occupational DC pensions have been focusing on information provision on the basis that members, like Max, would then make informed choices. However, insights from behavioural finance have shown that information provision, on its own, is no panacea. The availability of full information does not imply that Max behaves as "Homo Economicus" and makes 'informed decisions'. The report on Good practices for information provision for DC schemes (EIOPA, 2013) provided suggestions to make information provision more effective. This report aims to go beyond information provision and focus on effective investment decisions by looking at the concept of "**choice architecture**" from the behavioural finance literature.

21 Kattan (2006)

22 Ellsberg (1961)

23 Benartzi et al. (1999)

Introduced in the book *Nudge* of Thaler and Sunstein, this concept describes how the way choices are presented to people can have a significant impact on actual decisions and outcomes. However, Thaler and Sunstein (2003) highlighted that the “choice architect” is a person or collective that needs to be aware of several aspects of how people make decisions to support their choices, without over influencing them to choose a specific option. Much research has been conducted since then, also in the field of investment decisions and retirement planning. Table 1 below provides some general examples of how adjustments of elements of the choice architecture can effectively counteract certain behavioural biases²⁴.

Table 1 Examples of improving choice architecture (inspired from Johnson et al. 2012)²⁵

Cause for suboptimal decision making	Improving the choice architecture
Alternative / choice overload	Reduce number of alternatives / choices Use technology and decision aids
Decision inertia	Use defaults
Myopic procrastination	Focus on satisficing Limited time windows

In short²⁶, in the context of pension decisions, IORPs can potentially:

- aim to reduce the number of alternatives that members in occupational DC schemes have to compare;
- facilitate comparison by offering decision aids;
- introduce suitable default investment strategies;
- enable members to make satisficing choices instead of aiming for the optimal individual investment decision;
- enable members to make decisions within limited time (*windows*).

Where choices are complex, members can be supported by offering simple (*aggregate*) indicators of the relevant attributes of a choice (*e.g. total net returns, total level of costs*).

Recently, policymakers and supervisors are increasingly considering the relevance of “choice architecture” when developing new legislative and supervisory framework, as a tool seeking to influence/improve outcomes in situations where people exhibit behavioural biases (Lund²⁷; FCA²⁸).

24 For more elaborate description of the problems and effective tools of architecture we would like to refer to the article of Johnson et al (2012)

25 For details regarding behavioural biases please refer to chapter 2.3 “What are common causes of suboptimal investment decisions?”

26 For more elaborate description of the problems and effective tools of architecture please refer to the article of Johnson & al (2012)

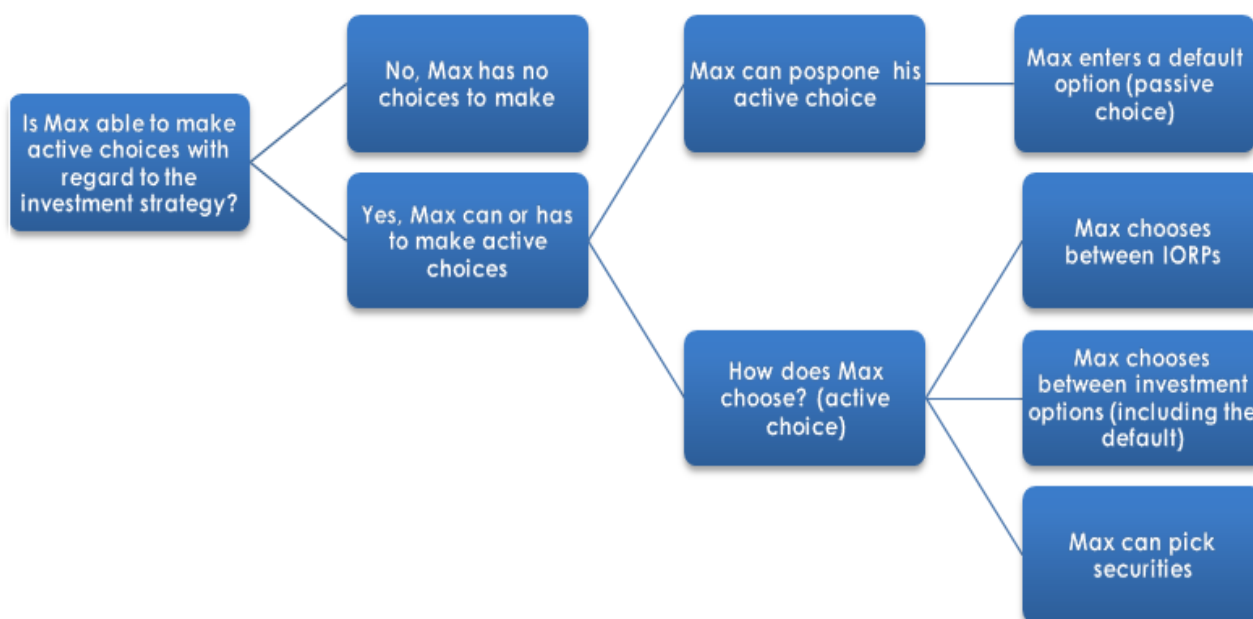
27 Lunn (2014)

28 FCA (2013)

2.4.1. No choice, passive choice, active choice

Taking Max's decision-making as the starting point, the aim is to first identify the characteristics of the choices that are offered and understand the way in which they are typically offered. Does Max have any choice to make with regard to the investment strategy? Where has Max choices to make, and in case Max does not make a choice, the availability of a default is further explored? Thus it is important to distinguish what exactly these set of choices are: are they among IORPs, investment options, or does Max have the ability to pick securities? And what is specifically done on behalf of Max in order to ensure that investment decisions are made in his interest. The following figure depicts a map of possible choices for Max in a European context.

Figure 1 Mapping the possibilities of choices for Max

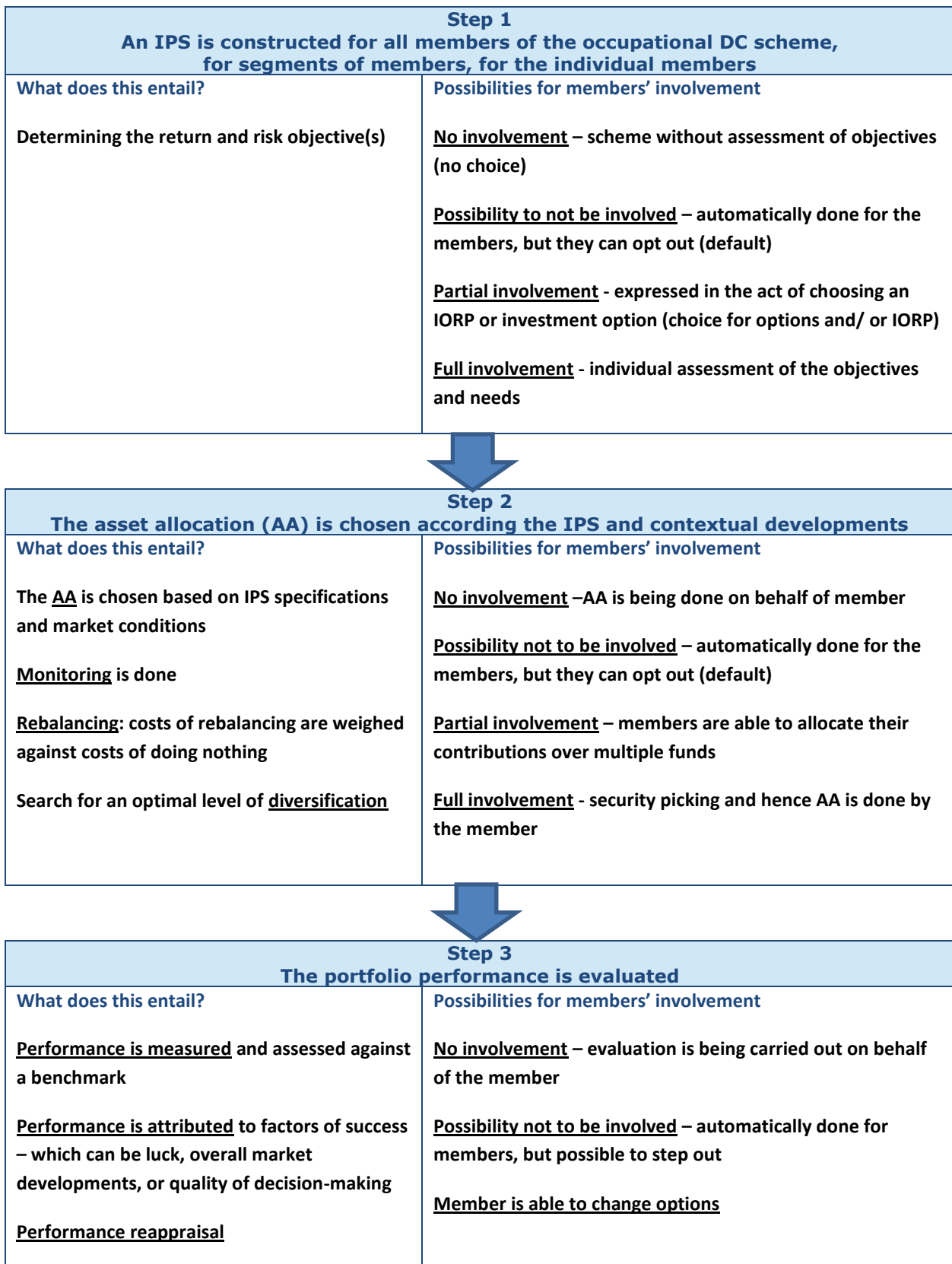


The figure above shows the basic structure of the questions that were posed to national supervisors. They could indicate whether certain choices were always, commonly, seldom or never offered to DC scheme members in their MS. It is important to stress that the structure described above is developed under **the premise that Max is part of an occupational DC pension scheme and is not outside the pension system**. The next section explores to what extent support is offered to members, for instance, 1) by taking into account characteristics of the target group in determining the investment strategy of the investment options and the default; 2) by providing personalised, simple information; or 3) by providing personal assistance or advice.

2.4.2. Getting to grips with choice architecture of occupational DC schemes

IORPs might offer members of DC schemes a greater or lesser extent of investment choice. In case of a great level of choice, members have to themselves assess their objectives, decide on a suitable strategic asset allocation and monitor and review their strategy. The following figure describes the various possible degree of member engagement at each of the three steps of the investment decision process.

Figure 2 Members' involvement in decision making process



Insights from behavioural finance research suggest that people tend to make suboptimal decisions in these steps (Shefrin, 2000²⁹). This implies that IORPs support members effectively by making decisions on their behalf and in their interest. At the same time, where more simplified investment choices are offered, the menu design and the framing of information appear to have a profound impact on decision-making.

Common mitigation techniques to deal with the tendency of members to make suboptimal decisions may include:

- **Investment governance**, whereby decisions are taken on behalf and in the best interest of Max. The extent of these decisions will also depend on how much is predefined in the law;
- **Default investment options**, in the event that Max chooses to take the path of least resistance and does not make an active choice. Default investment options are most likely to be present in occupational pension systems where occupational scheme participation is mandatory or semi-mandatory (*e.g. auto-enrolment with possibility to opt-out*) but are also offered in the case of voluntary participation (*investment governance is also a pre-requisite for the design of default funds*);
- **Limiting fund choices** available to Max (*this may or not include a default fund*);
- **Information provision** to support Max making decisions, but also in order to engage him over time;
- **Support or advice** to engage and support Max in making decisions (*e.g. decision aids, access to advice, etc.*).

29 Beyond Greed and Fear – Understanding Behavioral Finance and the psychology of investing, H. Shefrin, Harvard Business School Press, Boston, Massachusetts, 2000.

3. What are the 'Choice architectures' in European practice³⁰?

EIOPA's Database of pension plans and products in EEA provides some contextual statistical snapshot of pension systems in the EEA. In the EEA there are currently approximately 45 types of DC occupational plans/products with over 16 million active members that are fully bearing the investment risk of their future pensions³¹.

This chapter explores to what extent occupational DC schemes members are involved in making investment decisions, and which parties make the most important decisions within the investment process. The figures are based on the outcomes of a survey among national supervisory authorities. The following table provides an overview of the choice architecture based on the mapping exercise.

Table 2 Reflecting the choice architecture in a European context

MS	Members have no choices to make	Members can make choices	Members may both have choices or may have not ³²	Members can be defaulted (passive choice)	Members can choose IORPs	Members can choose investment options	Members can pick securities ³³
AT			X	X		X	
BE	X						
BG	X						
EL	X						
ES	X						
FI	X						
HU		X				X	
HR	X						
IE			X	X		X	X
IT		X		X	X	X	
LU			X	X		X	
LT	X						
NL			X	X		X	X
NO		X		X		X	
PL	X						
PT			X	X	X	X	
RO		X			X ³⁴	X	
SE	X						
SI			X	X	X	X	
SK		X		X		X	
UK			X	X		X	X
Total	9	5	7	10	4	12	3

When reading the analysis of the answers given by MS, one has to take into account that different schemes types do exist within one MS, with their own different possibilities and characteristics. The scope of the mapping exercise is to identify

³⁰ It is important to stress again, that the mapping exercise covers a picture of European practice, based on the answers received and on the number of MS that have provided feedback for this report.

³¹ Please note that this figure is an indicative, minimum estimate. EIOPA's database was developed on a best effort basis, with contributions from national competent authorities. The figure quoted here does not include membership volumes for all scheme types.

³² In the MS mentioned in this category, on the one hand there are pension schemes that do not leave any choice to members, and, on the other hand, are different pension schemes that do allow members to make choices.

³³ In few isolated cases, not being a common practice in either of the MS mentioned.

³⁴ In **RO** there are no formal IORPs but individual pension funds operating under IORP directive as informal reference by national legislation. In this paper personal pension funds are regarded as provider that falls under IORP directive.

common structures and characteristics that can be generally extracted from the information offered.

3.1. To what extent are investment choices made by or on behalf of members?

The extent to which members of occupational DC schemes are able to make choices with regard to the investment strategy varies throughout Europe (see Table 3). In 9 out of 21 MS members generally have no choices to make and in 5 of 21 MS, members are able to make choices. In 7 MS both types of choice contexts exist.

Table 3

In **9 out of 21 MS**, members generally have no initial choices to make while in **5 out of 21 MS**, members generally do have initial choices to make.

Members generally have no choices to make	BE	BG	EL	ES	FI	HR	LT	PL	SE
Members are able to make choices	HU	IT	NO	RO	SK				
Both of the above ³⁵	AT	IE	LU	NL	PT	SI	UK		

3.2. Where choices are made on behalf of members

3.2.1. Characteristics of the target group are often taken into account

For the 16 MS where investment strategy choices are taken on behalf of occupational DC schemes members, table 4 shows it is common for IORPs or other entities to take into account characteristics of the target group of members to be able to assess their return and risk objectives. In 12 out of the 16 MS these are always or commonly taken into account.

Table 4

In **12 out of 16 MS**, target group characteristics are always or commonly taken into account.

Are always taken into account	AT	ES	HR	PL	UK				
Are commonly taken into account	BE	EL	FI	LU	NL	PT	SE		
Are seldom taken into account	BG								
Are never taken into account	SI	LT							
Not possible to answer	IE								

The characteristics of the target group of members are translated mostly to an investment strategy for the whole group (see Table 4). **FI** is an exception as it only has one DC scheme. Investment strategy is changed into lower-risk strategy when a member is getting closer to a retirement age. Hence there are two segments which are based on the age of the members.

³⁵ In the MS mentioned in this category, on the one hand there are pension schemes that do not leave any choice to members, and, on the other hand, are different pension schemes that do allow members to make choices.

Table 5

In **10 out of 16 MS**, characteristics are always or commonly taken into account, furthermore these characteristics of the target group are translated into:

Individually tailored investment strategies														
Strategies that are tailored to segments of members	FI	UK												
Strategies for the collective, all members of the scheme	BE	EL	LU	NL	PL	PT	SE	AT	UK					
Not possible to answer	ES													

3.2.2. Various entities are involved in the investment strategy

Table 6

In **15 out of 16 MS** where investment decisions are taken on behalf of the members, the following entities are involved in determining the investment strategy:

IORP	BE	BG	EL	ES	FI	HR	LT	LU	NL	PL	SE	SI	AT	UK
Employer	BE	ES	LU	NL	PT	PL								
Collective of employers - industry level	BE	ES	PL											
External fund manager	BE	ES	PL											
External adviser	BE													
Other	PL	PT												

Table 6 shows the involvement of various entities besides the IORP in the investment strategy. In 14 out of 16 MS the IORP is reported as being involved in the investment strategy. In 6 MS it is the employer. However, collective labour agreements do not address the investment strategy, and the outcomes also suggest there is little involvement of external advisors (**BE**).

In **PT**, IORPs are autonomous entities without legal personality (*pension funds*) managed by pension fund management entities. Therefore, instead of the IORP, the pension fund management entity, classified in the category 'Other', is the one involved in the determination of the investment strategy.

In **PL** and **ES** there appears to be many entities involved in determining the investment strategy (*IORPs, the employer and collective of employers, external fund managers and so on*).

In **PL** a supervisory body of an occupational pension society is also able (*to some extent*) to determine an investment strategy of the fund. Occupational (*employee*) pension society is the manager of the fund and has a form of the joint-stock company with management board, supervisory board and general meeting of shareholders, as

statutory bodies. At least half of the seats in the supervisory board of an occupational society shall be filled by persons elected by members of the occupational fund.

In **ES** the investment strategy is made by the Control Commission of the IORP but it is delegated to the Management Entity. Furthermore, it is possible to have technical advice of a third party.

3.3. Where members of occupational DC schemes make choices

Table 7

In **12 out of 21 MS**, members can make active or passive choices

Default	AT	IE	IT	LU	NL	NO	PT	SI	SK	UK		
Choose IORP	IT	PT	RO	SI								
Choose investment options	AT	HU	IE	IT	LU	NL	NO	PT	RO	SI	SK	UK
Choose securities ³⁶	IE	NL	UK									

3.3.1. Often there is a default

This paragraph explores the characteristics of the default investment option. How the default is developed and what elements are considered important by supervisors in order to give members protection against the investment risks they bear.

In this report, the "default investment option" is defined as the investment option members of occupational DC schemes automatically enrol in if they do not make a choice. The member may still have the possibility to opt-out.

A member in a DC scheme can be enrolled in a default in different ways because:

- he has a choice but does not make one (*passive choice*);
- he made an active choice to stay in the default option.

A default investment strategy should reduce the possibility of unacceptable outcomes.

Table 8

In **6 out of 10 MS**, defaults are always or commonly designed by taking into account the characteristics of the target group:

Yes, always	SI	UK	LU	AT
Yes, commonly	NL	PT		
Seldom	NO			
No, never				
Don't know	IE			

The analysis shows that the default investment option is in principle available in 10 of the 12 MS where members of occupational DC schemes are able to make choices. This section of the report considers the default option in these 10 MS and seeks to analyse the differences and similarities in the various MS.

³⁶ In few isolated cases, not being a common practice in either of the MS mentioned.

As members are not monitoring the suitability of the default, it would be desirable if designers of the default would take into account characteristics of the target group. Table 8 suggests it is indeed common for the IORPs or other entities to take characteristics of the target group of members into account to be able to assess their return and risk objectives.

Table 9 below provides an overview of how characteristics of the target group are taken into account. Where defaults are available, half of the supervisors indicated that lifestyling is applied. Often this is due to legislation. The latter is discussed in the following sections. For instance, in **SI** lifestyling is applied. In **PT**, the default may consist of a more conservative option within the options available or be based on a lifestyling investment strategy. In **IT**, an automatic enrolment mechanism is in place; the default option set by law for "silent" members (*the target group*) is characterised by a low risk investment strategy.

Table 9

Characteristics taken into account with the default

Age / applying lifestyling	SI	NL	PT	IE
The objectives / goals of the target group	AT	NL	UK	
Capping the costs	UK			
Knowledge of the members	NL			
Average salary	NL			
Low risk investment strategy	IT	PT		

National authorities were asked to what extent investment strategies are tailored to individual members of occupational DC schemes. Most common strategy of the default investment option is tailored to the collective (*all members of the scheme*), followed by an investment strategy tailored to segments of members. No MS have reported the individual tailored strategy.

Table 10

In **7 out of 10 MS**, default investment strategies are meant for all the members of the scheme and not tailored to segments of members or individual members:

Individually tailored strategies							
Strategies tailored to segments of members	SI	UK	NL				
Strategies for the collective, all members	IT	NO	LU	NL	PT	IE	AT
Other							

Subsequently, supervisors were asked about who is involved in determining the investment strategy of the default.

- Interestingly, in most (8 out of 10) of the MS **the employer is directly involved in the determination of the basic investment strategy for the default investment option**;
- the IORP is involved in the determination of the investment strategy in 6 out of 10 MS;
- **NO** is not answering the questionnaire for IORPs, but decisions are made by the life insurance company as a deliverer of pension products;

- **SI** is referring to the governance structure in designing the default. Each pension fund, where lifecycle is incorporated in the fund rules, must have a pension fund committee, with 2 committee members who are representatives of employers and 3 committee members which are representatives of pension fund members. The competence of the pension fund committee is, among others, to give opinion to all changes of investment strategy;
- For **PT** the category 'Other' includes the pension fund management entities;
- In **IT**, the auto-enrolment system in place is set by law. All IORPs entitled to receive "silent" members have to offer a default option with a conservative strategy.

Table 11

In **8 out of 10 MS**, the employer is involved choosing the default strategy:

IORP	AT	SI	UK	LU	NL	IE		
Employer	AT	NO	SI	UK	LU	NL	PT	IE
Collective of employers - industry level	NL							
They are result of collective labour agreements								
External fund manager								
External adviser	IE							
Other	NO	SI	PT					

Looking at the typical investment strategies of the default investment option, Table 12 shows that lifecycling is the main strategy (7 out of 10), followed by the conservative strategy (3 out of 10) and the balanced strategy (3 out of 10).

Table 12

In **7 out of 10 MS**, the default investment strategy may consist of lifecycling:

Conservative	LU	PT	IT				
Balanced	NO	IE	LU				
Lifecycle	NO	SI	UK	NL	PT	IE	LU

The Appendix (A) provides definitions of the different investment categories of default funds.

Table 13

In **3 out of 10 MS**, a guarantee is always or commonly provided

Yes, always	SI	IT		
Yes, commonly	PT			
Seldom	AT	UK	NL	
No, never	NO	IE		

Table 13 suggests that the default investment option always (**SI**, **IT**) or commonly (**PT**) provides a guarantee in 3 MS (out of 10).

Conclusions

Based on the answers provided by national authorities, there are similarities and differences in the approach for occupational DC pension schemes within the EU/EEA, which can be summarised as follows:

In 10 out of 12 MS where members can make choices with regard to the investment strategy **a default investment option is often in place.**

Most of the MS (7 out of 10) **have default strategies that are designed for all members of the scheme.** A few (3 out of 10) have default strategies that are tailored in segments of members.

In most cases the employer is involved in the determination of the default investment option (8 out of 10), followed by the IORP (6 out of 10).

The case of **SI** shows that an extensive governance structure might be of importance in the design of a default investment option. We get back to this in the following chapters.

In most MS (7 out of 10) **the default strategy may consist of lifecycleing.** In other MS the default strategy may be conservative (3) or balanced (3).

In almost a third of the MS (3 out of 10) **the default investment option always or commonly provides a guarantee,** in the rest seldom or never.

It has become clear that the default plays an important role in Europe with occupational DC pensions. By far the biggest part of the occupational DC-pension schemes members are enrolled in a default investment scheme. In many cases, this is not because members actually choose to be in the default but because members suffer from inertia: *because they finally do not make a decision at all, and are just auto-enrolled in the default*³⁷.

This makes the default extremely important. It is important to make sure that the default is always prudent and in the interest of the members, it has to be regularly monitored whether the market conditions and target group of members' circumstances are still the same as it was at the start of the contract. Thus, as previously mentioned in the theoretical framework of chapter 2, after building the Asset Allocation continuous monitoring and feedback would lead to regularly reviewing if the asset structure is compatible with shifting market conditions and changing circumstances of the target group.

3.3.2. Target group taken into account when determining investment options in the case of occupational DC schemes

MS were asked if IORPs and/or other entities take into account the characteristics of the target group, like their risk and return profiles when deciding on the investment strategies of the options available. The following table summarises the answers that were provided by MS where members can make active choices.

³⁷ Johnson et al (2012); NEST (November 2014): "*International evidence suggests that being defaulted into a pension makes members less likely to make an active fund choice. In the USA, new hires into a 401(k) plan featuring automatic enrolment were three times more likely to invest all of their contributions in the default fund, with 67 per cent doing so compared to 21 per cent. 70 per cent of Chileans in the multi-funds system do not make an active investment choice.*"

Table 14

In **8 out of 12 MS**, characteristics are always or commonly taken into account:

Are always taken into account	AT	IT	LU	RO	SI	UK
Are commonly taken into account	HU	PT				
Are seldom taken into account	NO	NL				
Not possible to answer	IE	SK				

In 6 MS IORPs and/or other entities always take into account - to some extent - the characteristics of the target group, like their risk and return profiles, whereas in 2 MS (**HU** and **PT**) the characteristics are commonly taken into account and in 2 MS (**NO**, **NL**) only seldom.

As a follow-up question, MS were asked to briefly indicate how the characteristics of the target group were taken into account. 6 MS provided information.

In **IT** pension funds are required to analyse the characteristics of the potential target group before setting out their investment options.

PT clarified that, when more than one option is available, the options commonly have embedded different risk and return profiles, either resulting from the composition of the underlying assets' portfolio or the existence of investment guarantees. So, the investment strategies of the available options may not necessarily be decided taking into account the characteristics of the target group, but different risk and return profiles are offered so that each individual can choose the option which better reflects its own risk and return profile.

In **RO** they generally take into account the risk profile of members in building their specific investment strategies (*per pension fund*).

SI clarified that lifecycle has exactly three sub funds with different investment strategy (*aggressive, moderate and conservative – guaranteed investment return*) tailored to three age groups defined by the provider.

In **UK** the scheme's default option should be designed with the likely membership profile in mind and should follow certain standards on the objective, suitability, affordability and managing risk. Moreover, stakeholder pensions have to meet certain government standards to ensure they are flexible and have a limit on annual management charges (*e.g. a cap of 1.5% for policies issued after April 2005 for the first ten years and 1% thereafter*). Furthermore, the UK government will cap auto-enrolment pension charges at 0.75 per cent from April 2015. The cap will be significant for millions of people who are being automatically enrolled into workplace pension savings.

IE raised the concern that taking into account the characteristics of the target group is not always the case.

MS were asked who is involved in determining the investment strategies of the range of investment option that are offered. The following table summarises the answers that were provided by MS where members in occupational DC schemes can make active choices.

Table 15

In **the 12 MS**, the following entities are involved in determining the investment strategy:

IORP	AT	HU	IT	LU	NL	RO	SI	SK	UK
Employer	AT	IT	LU	NO	PT	SI	UK		
Collective of employers - industry level	IT								
External fund manager	HU	IE							
Other	IT	NO	PT	SI					

In almost all MS, except for **IE**, the IORP and/or employer is involved in determining the investment strategies of the range of investment options that are offered.

In **NL** the employer sometimes determines in what way an employee can make active choices. However, the IORP determines the investment strategy.

In **IT**, IORPs are responsible to define their investment strategies and to fix them in a document of investment policy (IPS). Being part of the governing body of contractual pension funds, representatives of employers and employees are also involved in the definition of the general investment strategy of the IORP.

In **PT** pension fund management entities and also the employers are involved.

In **SI** the IORP and the employer determine the investment strategies. **SI** clarified that each pension fund, where lifecycle is incorporated in the fund rules, must have a pension fund committee, with 2 committee members who are representatives of employers and 3 committee members which are representatives of pension fund members. The competence of pension fund committee is, among others, to give opinion to all changes of investment strategy.

In **IE** the external fund manager determines the investment strategy. IE mentioned that according to their feeling the investment strategies are in place for reasons of inertial or culture rather than fresh objective consideration.

3.3.3. Often limited choices for members

The following section examines to what extent members might have to make choices in the context of DC occupational pensions:

- do they choose between IORPs and/or investment options?
- do they need to take into account the time horizon and perhaps additional technical aspects of the investment strategy, such as diversification and liquidity of the portfolio?

The chapter explores occupational DC pension systems where members do have the possibility of expressing their investment choices in a more limited or permissive manner. As such, based on their personal profile, risk tolerance and return desires, members in occupational DC schemes may self-influence the investment strategy in order to meet their perceived retirement needs.

In the context of this paper, "active choice" is regarded specifically as the possibility of members to willingly and directly express an investment choice with regards to: choosing a IORP (*including the possibility to transfer or choose multiple IORPS*), choosing an investment option within a IORP (*or multiple ones*), or, rarely in practice, choosing to alter the investment strategy by choosing securities and the specific asset allocation.

From a total number of 21 members states for which national supervisors have participated in the exercise of data collection, it has been found that in 12 of them scheme members have a practical or theoretical possibility to make personal active choices in the investment of their pension financial resources. In **HU**, the IORP may optionally offer members the possibility to choose from several investment schemes. In **AT**, members may choose from within 5 lifecycle investment strategies, and IORPs may choose their specific investment strategy.

Basic choices for active scheme members

Table 16

In **12 out of 21 MS**, members can make active choices

Choose IORP	IT	PT	RO	SI									
Choose investment options	AT	HU	IE	IT	LU	NL	NO	PT	RO	SI	SK	UK	
Choose securities ³⁸	IE	NL	UK										

Choice 1 - IORP

One possibility for members when entering the pension system is to choose among an existing set of IORPs³⁹. In **PT**, with regard to open pension funds, DC schemes may be financed through several open pension funds, thus allowing its members to make a choice. In **IT**, the IORP to which members may adhere is identified by default, given the employer to which the members belong; there is an opt-out choice also towards personal plans but members may lose their employer's contributions. In **RO** members may transfer from their voluntarily chosen pension fund (with a set penalty if the transfer in within the first two years from enrolling into a fund), or may choose to become members to more than one pension fund.

Choice 2 – Investment option

Connected to the decision of the IORP that will manage the retirement financial resources, there is the decision to opt among investment strategy options (where/if available). In this report, "investment option" defines the general investment strategy (including asset structure/allocation, geographical distribution, sector/industry distribution, investment limitations and targets, details regarding the net return and risk objectives etc.) that a IORP aims to achieve and, generally, it is thoroughly described within the IPS.

In most MS where members make active choices, the number of investment options offered by IORPs ranges from 2 to 5 (8 out of 12 MS). In most MS (7 out of 12) members may also opt to contribute to more than one specific investment option, thus having the possibility to increase the level of diversification of their retirement portfolio.

Choice 3 – Consider employer's stock in security picking

One important issue generally occurring in portfolio management, and also applicable in pension investment where members make active choices regarding their asset allocation in occupational DC schemes, is the possibility of members to direct their assets in their own company's stock (usually perceived as better due to the informational advantage that individuals think they have and the trust in the success of their employer).

³⁸ In few isolated cases, not being a common practice in either of the MS mentioned.

³⁹ In **RO**, as previously mentioned, there are actually pension fund managers, not IORPs.

Security picking is not a common practice among MS, sparsely existing as an option for members of only 3 MS (**IE**, **NL** and **UK**). Given this context, investing in employer stock is not a concern related to member's personal biases, but it is rather addressed at IORP level.

This is a subject specifically addressed by the IORP Directive in Article 18, specifying that investment in sponsoring undertaking shall be no more than 5% of the portfolio, or 10% in the group when the sponsor belongs to a specific group. As such, this has been translated in the national legislation of MS and it is applicable to all pension schemes under the IORP Directive.

Continuous choice making

Once individuals have become members of a specific scheme and once they have chosen an investment strategy within an IORP, the question comes if they can further continue to exert their ability to make active choices. This seems to be always the case.

A high level of active choices may, however, be overwhelming or not of interest for members. For example, evidence shows that in **UK** members manifest very little interest in shaping the asset allocation of their investments. This might be the effect of choice overload or attribute overload, triggering a behavioural response where individuals facing too many options or too much information choose not to take action at all rather than understanding and weighting all their possibilities. It may also be an impact of framing, regarding the way their choices are presented and explained to them by the IORPs, sponsors or other entities involved.

The level of choice

The level of choice during the decision making process differs significantly on the basis of the very structure of pension systems in each MS. For instance, in **RO** and **SI**, members may only exert an active choice by electing between IORPs (fund managers) or funds managed by a specific IORP. However, in **SI** they may also browse from sub funds based on lifecycling. All other decisions are taken by the pension fund manager.

The level of active choices that reaches the highest level of detail and flexibility, and that does give a member the complete liberty of building a strategic asset allocation is found in the cases of **NL**, **UK**, and **IE**, where members may actually pick individual securities for their pension fund portfolios. **These, however, are isolated and particular cases, and do not represent the general options available to all members for all schemes.**

On the other hand, an important option members may have as a decision tool is also the opt-out or transfer option that offers members the possibility of shifting away from their initial investment strategy.

The time horizon and other adjustment factors

Some important factors that are taken in account when dealing with adjustments or choices regarding an investment strategy are: the time horizon, the need for diversification and the liquidity. These needs change during the lifetime of a member by the simple passage of time, but also through shifting market conditions, changes in the levels and structure of financial and human capital, or by changing personal preferences.

These factors are taken into account by IORPs and other entities involved in the investment process through building specific scheme structures and investment options. However, in some cases these factors also *need to/ can be* taken into account by members themselves when the latter make active decisions.

First of all, when making active choices for retirement investment, members always or commonly take the time horizon in account (in 7 out of 12 MS). This is an important risk factor that influences the members' ability to expose themselves to a given level of investment risks.

Table 17

In 7 out of 12 MS, members always or commonly make active choices in order to take the time horizon into account

Always	HU	SK			
Commonly	NO	IE	IT	LU	NL
Seldom	UK				
Never	AT	NO			

Secondly, diversification is a prerequisite of all investment strategies in order to minimise or eliminate unsystematic risk⁴⁰ (*company/sector/investment specific risk*), a risk for which financial theory evokes that the investor is not rewarded. Although being a crucial factor in any investment portfolio building, diversification is not an issue that members themselves have to commonly regard when expressing their active choices. An increased level of diversification can also be achieved purposely or less intentionally when members choose for more than one investment option.

Lastly, liquidity is another factor that influences the members' ability to take risk and determines the desired asset structure of retirement resources at one point in time. Again, this is not an issue that members have to commonly regard themselves when making active investment choices.

Conclusions

In MS where active choices are possible and allowed in occupational DC pension schemes, the level of choice and flexibility varies significantly among MS and within specific options available in a particular MS. The spectrum ranges from very flexible options where members may engage even in security picking (***even though it is not common practice***) to more rigid ones, where members may exert their choice only at the level of the IORP / pension manager and the funds managed by these financial companies.

Moreover, although the time horizon seems to be an important factor taken in account when members make active choices (*choosing an investment option, or sub strategy based on lifecycling*), liquidity and diversification are aspects that are less commonly considered by members themselves in the decision making process. Furthermore, even in MS where members do have a higher level of active choice making, seldom do they manifest real interest of engaging in the investment decisions of their retirement portfolios.

3.3.4. Limited support for members making choices

As noted in the previous section, it seems that liquidity and diversification of investments are no factors that are commonly taken into account in MS where

⁴⁰ Unsystematic risk is the specific risk of a particular investment, a risk that can be diversified away through the composition of portfolio. On the other hand, systematic risk is the overall market risk that cannot be eliminated through diversification and it is the risk for which the investor is rewarded through return.

members can make active choices. However, members' financial skills are generally not well developed and retirement is especially a difficult topic (*as it is perceived as far away in the future*). Therefore, it is even more important to support members and to ensure the availability of appropriate advice.

The responses received from MS reveal that there are currently no uniform approaches and rules among MS on how to deal with information matters when scheme members can make active choices. Even if there is no clear approach regarding which members do receive support from, it nevertheless appears that in most MS members do have the possibility to receive some assistance when choosing between investment options. This support is either actively provided or it is available on request. It is questionable whether this option is linked to the potential additional administrative costs generated by such assistance.

Based on the questionnaire replies, it emerges that only in 12 MS members can make active choices in all or part of occupational DC pension schemes⁴¹.

Table 18

In **4 out of 12 MS** where members can make active choices, there are some initiatives in information provision, which are not legally required or initiated by supervisors, and that are effectively helping members to make investment choices:

Yes	NL	NO	PT	UK
No	HU	IE	LU	SK
Not possible to answer	SI	RO		

With regard to the type of support provided to pension scheme members with free management choice, it emerges from Table 18 above that only in 4 out of 12 MS initiatives in information provision occur even if not legally required or initiated by supervisors. However, Table 18 shows that in 4 out of 12 MS such initiatives do not exist. Members from 2 out of these 4 MS are not automatically enrolled in a default option, in case they do not make any active choice (**HU, SK**). In **IE**, members are typically enrolled in a balanced investment option.

One MS specifically stressed the importance of communication methods, such as describing the investment process. In fact, it is assumed that further information provision helps members to understand what happens to their financial resources and, thus, "nudge" them to make more effective investment choices. The other affirmative responses reveal that complementary information usually refers to supplementary investment policy/option related information.

41 **UK, NO, NL, PT, SK, RO, SI, LU, IE, HU, IT, and AT.**

Availability of automated decision tools to assess the appropriateness of choices available

Table 19

In **5 out of 12 MS**, where members have choices to make, there are automated decision tools available to members allowing them to assess the appropriateness of choices available:

Yes, always	IT	SK				
Yes, commonly	NL	NO	UK			
No, never	HU					
Not possible to answer	IE	LU	PT	RO	SI	

5 out of 12 MS reported that there are automated decision tools commonly available allowing members to assess the appropriateness of their choices. Table 19 shows that it is a common practice in 3 MS and that it is always the case in **SK** and **IT**. Another 5 out of 12 MS do not have the necessary information to provide an answer to this question. It appears from the responses received that, in **SK**, even if members are not enrolled in a default option, in case no active choice has been made, there are tools available to assess their appropriateness of choices. Furthermore, it emerges from Table 20 below that scheme members from **SK** can also receive personal assistance from IORPs, supporting them in choosing between investment options. In **IT**, IORPs are required to make available on their websites a tool that provides an estimate of the retirement benefits that members could reasonably expect to receive at retirement when different retirement decisions (i.e. contributions, investment options) are considered. Pension projections are based on conservative assumptions set by Covip, related to real rate of returns, to the inflation rate and life expectancy assumptions. The assumptions are the same for occupational and personal pension plans.

Table 20 below shows the parties involved in terms of providing tools allowing members to assess the appropriateness of choices available. It emerges that in 5 out of 12 MS tools are usually provided by IORPs, followed by employers (2 out of 12). **IE** does not have the necessary information to provide an answer to this question.

Table 20

In **5 out of 12 MS**, members have choices to make, these tools are provided by:

IORPs	IT	LU	NL	SK	UK
Employers	LU	UK			
External financial adviser	UK				
Not for profit or governmental organisations	UK				
Other	NO				
Not possible to answer	IE				

Personal assistance supporting members in choosing between investment options

Table 21

In **10 out of 12 MS**, where members have choices to make, personal assistance is available to support members in choosing between investment options:

Yes, always	SK	RO			
Yes, commonly	IT	HU	LU	PT	UK
Seldom	NL	NO	IE		
Not possible to answer	IE	SI			

In most MS (10 out of 12) where members have freedom of choice in occupational DC pension schemes, they do have almost always the possibility to receive personal assistance when choosing between investment options. 2 MS do not have the necessary information to provide an answer to this question (**IE** and **SI**). It emerges from the responses that even if members in **RO**, **HU** and **SK** are not enrolled in a default option when no active choice has been made, scheme members do receive in principle support when choosing investment options.

Table 22

In **8 out of 12 MS**, the support is provided by the following entities:

IORPs	HU	LU	SK	IT	UK
Employers	LU	UK			
External financial adviser	PT	RO	SK	UK	
Not for profit or governmental organisations	UK				
Other	PT				
Not possible to answer	IE				

It appears from Table 22 above that the support is most commonly either provided by the IORP (5 out of 12 MS), by an external financial adviser (4 out of 12 MS) or by the employer (2 out of 12 MS). One MS does not have the necessary information to provide an answer to this question (**IE**).

Table 23 below shows that there is a great variety on whether the support is actively provided or it is provided on request to scheme members. In **RO** and **HU** support is actively provided to scheme members, which is appreciated due to the fact that members are not automatically enrolled in a default option when no active choice has been made. However, in **PT** and **SK** the support is available only on request. In **UK**, support is either available on request or actively provided to scheme members. 2 MS do not have the necessary information to provide an answer to this question (**IE** and **LU**).

Table 23

In **3 out of 7 MS** that provided an answer, it emerges that the support is actively provided to members:

Actively provided	HU	RO	UK
On request	PT	SK	UK
Not possible to answer	IE	LU	

Table 24

In **5 out of 7 MS** that responded to the question, the support is available on an ongoing basis:

Yes, commonly	HU	LU	SK	PT	UK
Never	RO				
Not possible to answer	IE				

Table 24 above shows that generally (with the exception of **RO and IE**), support is still available after the initial choice, hence on an ongoing basis. One MS indicated it did not have the necessary information to provide an answer (**IE**). Here again, it is interesting to read that the support is in principle available on an on-going basis in **SK** and **HU**, MS where members are not enrolled in a default option in case no choice has been made.

Comparison of investment options in terms of risks, costs and rewards

In terms of main characteristics, such as costs, risks and rewards, another question of the survey was to find out what members of occupational DC pension schemes can do to compare different investment options available in case of free choice management. The results show that in 4 out of 10 MS that responded to the question, information on costs, risks and rewards is actively provided to scheme members. In 4 out of 10 MS information provision is both actively provided and available on request. However, in 3 out of 10 MS, information on costs, risks and rewards is only available on request.

Results show that usually more detailed information is only available on request. In this context, it has to be mentioned that according to article 11 (4) of the IORP Directive, each member bearing investment risk shall also receive, on request, detailed and substantial information on the range of investment options, if applicable, and on the actual investment portfolio as well as information on risk exposure and costs related to the investments.

If available on request, information on costs, risks and rewards can be usually obtained from the IORPs or the providers (*on paper, via dedicated websites, etc.*). This is the case in **UK, RO, SK** and **PT**. However, in **SI**, the provider must send the current investment strategy in hard copy to the members. In **NL**, in order to obtain supplementary information, members have to ask an external financial adviser. In **IE**, information can be obtained from the IORP or the employer.

Table 25

In **3 out of 8 MS** that responded to the question, information is comparable / standardised:

Yes	IT	RO	SK		
No	IE	PT	NL	SI	UK

It appears that information provided to scheme members of occupational DC pension schemes in order to compare different investment options is not standardised, hence not comparable in terms of costs, risks and rewards. In 5 out of 8 MS information is not comparable. However, 3 MS reported that most information is standardised (**IT**, **SK**, and **RO**).

With regard to the question whether this information is personalised, it appears that personalised information exists in several MS, but often only on member's request. It also depends on the kind of information. Features like available investment options, and risk and return indicators are usually not personalised.

In **IT**, in order to allow potential members to compare the "price" applied by different pension plans, the supervisory authority (Covip) requires that pension funds display on the pre-contractual information document and on the supervisory authority website a cost indicator (**Synthetic Cost Indicator - SCI**) that is computed considering all costs charged in percentage of the total assets. The methodology to calculate SCI and returns is set by Covip and is common for all different kinds of pension funds.

In this context, it is also worth to underline that financial advice is also bringing to view a significant cost factor that has to be taken into account. Individual financial advice is expensive and therefore *perhaps* not widely available.

3.3.5. Hardly any support for members of occupational DC schemes to analyse their risk and return objectives

This paragraph tries to answer to what extent members of occupational DC schemes throughout the EU/EEA that can make active choices get support in knowing their risk and return objectives prior to choosing an investment option.

Generally, one should expect where more and more complex decisions need or can be made by members, that members are also offered more support in knowing their return and risk objectives. The way the support is provided to members also influences the use of this support and therefore the chances of this support to be incorporated into the decisions members are making.

Support during decision-making process

When active choices are available to members, one would expect that more assistance is available, in order to address inertia and/or choice overload by helping members to structure the decisions they need to make. As a result, MS were asked to indicate where members can make choices, whether people are supported by IORPs or other entities to assess their individual characteristics, return and risk objectives.

Table 26

Before members choose an investment strategy, do they get support from IORPs or other entities (e.g. employers, external fund managers) to assess their individual characteristics, their return and risk objectives?

yes, always	AT						
yes, commonly	NO	HU	UK	LU	SK	NL	
Seldom	IT	PT					
No, never	RO	IE					
Don't know	SI						

Out of the 12 MS that indicated that the investment strategy can be actively chosen, **HU, UK, LU, NO, NL** and **SK** indicated that support is commonly provided to members for their decision making by assessing the individual's characteristics, return and risk objectives. In **AT**, this is always the case.

Table 27

Is the support actively provided or available on request?

actively provided	UK	LU	IT	HU	AT	NL	
on request	UK	LU	IT	SK	PT	NO	AT
Don't know	SI	IE					
Not applicable							

Besides the actively provided support, members can also get support on request. In 7 out of 12 MS support in assessing the individual's characteristics, return and risk objectives is provided on request. In these MS members are designated to request for information, since no support is actively provided to them about the investment strategy. In **UK, LU, IT** support is available on request but also actively provided.

Who is providing support?

Table 28

Who is providing this support?

IORPs	HU	UK	LU	SK	IT	NL	AT
Employers	UK	LU	SK				
External advisors	SK	PT					
Not for profit or governmental organizations	UK						
External fund manager							
Other	PT	NO					
Don't know							
Not applicable							

In **HU** and **NO**, members are only supported in this process by one source (for **HU** the IORP). More sources of information are available in **LU** and **PT** (*two different sources*) and in **UK** and **SK** the most sources of information co-exist, with members having three different sources of information available. Hence, there is no significant difference between the numbers of sources of support available between commonly supported or seldomly supported members.

When information is only provided on request, results show that in these circumstances the information is usually not given by the IORPs themselves, but by different entities- external advisors, employers, insurance companies and external fund managers. In **PT** and **SK**, where information is only provided upon request, we also see a large number of different sources of information providers. In these two MS a cumulative number of 4 different categories of sources of support are available to help members in assessing their characteristics and risk and return objectives (*IORPs, employers, external advisors and other sources*).

How are characteristics assessed?

When members are able to make active choices, either between IORPs or investment options, it is important that members get help in determining their own individual characteristics regarding their return and risk objectives. So, the first information needed by members, is the understanding of how much return they require from their retirement portfolio in order to meet their primary goals (*or partially meet them if other sources are available to them after retirement*). An unequivocal method of getting to know their characteristics enables them to also shop around to find the best suitable IORP and or investment strategy (*within that IORP*).

9 MS indicated that support is provided (*regardless of active or on request*). From these 9 MS, 4 indicated how this is most commonly assessed.

Table 29

When support could be provided to members, how are individual characteristics, return and risk objectives of the members most commonly assessed?

By getting in contact with members and asking them in a conversation	UK	LU	SK	IT	
Through internet service questioning	NO	UK	LU	IT	NL
By getting members to fill in a paper questionnaire	UK	LU	IT	NL	
Other	AT				
Don't know	HU	PT			
Not applicable	IE				

SK indicated that this is most commonly assessed by getting in contact with members and asking them in a conversation about their individual characteristics, return and risk objectives. **NO** indicated that this is done through internet service questioning. **UK** and **LU** indicated that this is usually done by getting in contact with members and asking them in a conversation, through internet service questioning or a paper questionnaire.

NO, **UK**, and **LU** mentioned that a form of questionnaire (either online or paper-based) could also be used to make the assessment.

Table 30

Are methods for assessing the characteristics, return and risk objectives, of the target group to some extent standardised across these types of schemes?

Yes	NL							
No	NO	HU	UK	SK	IE	IT	LU	
Other								
Don't know	HU	PT						
Not applicable	IE							

A form of standardisation would make it easier for participants to be able to compare different options and help them assess whether the chosen option suits their situation (*again this would prevent choice overload and inertia and help structure decision making*).

Ongoing support

Next to support in the initial decision phase members were also asked about whether this support would also be available after the initial sign up of the member, e.g. is on-going support available for the members.

Table 31

Is this support also available to the member after the initial choices are made, hence on-going?

Yes, always	AT						
Yes, commonly	NO	HU	UK	LU	SK	IT	NL
Seldom	NL	PT					
No, never	RO	IE					

The ongoing support is provided largely the same way. 8 out of the 11 MS that answered this question indicated that members are always or commonly supported on an ongoing basis in assessing their characteristic and risk and return objectives. **NL** and **PT** indicated that ongoing support is seldom provided.

Conclusions

When members have the ability to make active choices in occupational DC pension schemes, more support is available to them compared to when no choice is available. However, most of this support should be requested by members.

In these circumstances one may question how the information is adapted to member's information processing needs. The number of schemes available is an important variable. When the number of IORPs and/or schemes is limited the choice overload is also limited and the need for support might decrease.

It also becomes clear that most information is actively provided, and that actively provided information is provided by the IORPs. This leads to the implication that the information is more scheme-oriented than member-oriented. Therefore, it can be expected that when help is available on request it is used less frequently by members.

Based on contextual research, one way of deterring such a phenomenon would be, for example, to offer the requested information free of charge. However, this does not address the matter directly when member engagement is inherently low.

Finally, some of the assessments about members' characteristics and the risk and return objectives could be done by questionnaire. In these situations it is difficult for members to assess what IORPs or investment strategies would suit their risk and return assessment.

4. Important risks and legal and supervisory approaches

Generally, **rule-based supervision is most commonly reported by national supervisors** (11 out of 21), whereas an almost equal number of MS is basing their supervisory activities equally on rules and principles (9 out of 21). A few MS however indicate that they do not counteract harmful activities of the IORP when there is no legal basis (3 out of 21).

The perception or actual situation of the 'market' might well be influenced by the focus of supervision. Although requirements to take the suitability of the investment strategy into account do not often exist, supervisory activities often focus on the investment strategies. Even so, very few indicate they undertake activities to ensure the support of IORPs or other entities to members (3 out of 12).

Where choices can be made in occupational DC pension schemes, supervisors seem to focus on the investment strategy and compliance with investment rules, and to a lesser extent on the suitability of the options (5 out of 12) or of the default (4 out of 9). Where members have no choices to make, suitability seems a more important consideration for supervisors (11 out of 16). This might at a first glance seem logical, assuming that, where possible, members are assessing the options and their suitability themselves.

However, behavioural finance shows that menu design matters. People do not tend to assess underlying risk and return profiles of the options available, but only compare the set of options offered. Furthermore, due to inertia, large part of the people will tend to stay in the default without reviewing its suitability. Taking these facts as a starting point for occupational DC pension schemes, it is as important to ensure suitable options, and a suitable default, as it is to have a suitable investment strategy for a scheme where no choices can be made. Therefore, **more research should be directed towards methods of better addressing the suitability of the investment strategy of the investment options and the default** with regard to the target group of the occupational DC scheme⁴².

4.1. Risks perceived by supervisors

Based on the answers received, national authorities perceive different sets of risks for the different pension systems: where members have no choices, where there is a default, and where members have a limited set of active choices that they can or need to make.

As such, when members have no choices to make in occupational DC pension schemes, the main risk envisioned by supervisors is:

- legislation and supervisors may over focus on compliance and may not give enough attention to matching investment strategies to members' risk and return profiles;

When a default option is in place in occupational DC pension schemes, supervisory authorities detect the following main risk categories:

- the default option may be too broad and general and will not meet the return and risk objectives of each of the main different groups of members;

⁴² This subject is a central thrust of the recent UK proposals, as the government has outlined in their recently published draft of regulations.

- based on the inertia associated with auto-enrolment, the situation occurs when members will not take the opportunity to assess their own return and risk objectives so as to ensure that the default option actually suits their profile;
- members do not monitor whether the investment strategy changes with their risk and return profile in time;
- members purposely change their objectives and goals without communicating with the scheme manager. Therefore, the default becomes inappropriate.

In the case of occupational DC pension schemes where members do have limited active choices that they can or have to make, the following risks are perceived by national authorities:

- members are not able to assess their own risk and return objectives in order to make optimal decisions;
- members are confronted with too many choices (range of choices or products) that are difficult to compare to make a good decision and are also difficult to supervise;
- based on lack of skills and / or experience, those providing support to members may not act in the best interest of the members;
- members may not make a complete and relevant assessment for their choice. For example based solely on his/her risk objective a member may choose a safe option (*guarantee*) which from a return perspective is suboptimal (*costs overweight benefits*).

4.2. Suitability for the target group and risk mitigation techniques

One common question that was asked with regard to investment options, defaults as well as for schemes where members have no choices to make, was whether there are supervisory or legal requirements in relation to the assessment of characteristics of the target group, risk and return objectives, which need to be taken into account. **The suitability of the investment strategy with the addressed target group was identified as a main risk by national supervisors for all types of occupational DC pension schemes.**

The conclusion is that there is no consistent approach to ensure a proper assessment of the return and risk profiles of members. In some MS there is a more direct approach to mitigate this risk (*for example in NL there are requirements for risk and return assessments to be made for members*) or less direct, where such mitigation techniques are rather ad-hoc, with proactive or at request assessments (*online and / or paper based questionnaires*).

This section examines the main groups of techniques to mitigate risks perceived by national authorities. Although several mitigation techniques have been identified for a specific risk or a group of target risks, their applicability and suitability to each pension system and MS needs to be assessed. The following mitigation techniques would be chosen by each MS in comparison to other ones by conducting a cost-benefit trade-off analysis and assess its value for money for each entity involved in the pension system.

4.2.1. Scheme characteristics

One principal method of addressing the risks described previously is for national supervisory authorities to shape specific schemes characteristics. Methods described by national authorities include:

Requiring Lifecycling / Lifestyling – life cycling is an important element of schemes characteristics in **SI** (*3 sequential funds: aggressive, moderate, and conservative, where the latter provides a guarantee*), and **NL** (*the national supervisor investigates lifecycle schemes, sometimes at the IORP's headquarters; the supervisor also sends out assessments on this topic and publishes reports newsletters to influence IORPs*). Lifecycling addresses the time-horizon appropriateness of the investment strategy taking into account members' profiles.

The default membership –in MS where members are enrolled in pensions by default, such as automatic enrolment in the **UK**, this approach is successfully addressing the issue of declining and low participation in occupational pension schemes and other forms of pension saving.

Caps on costs - Stakeholder pensions in **UK** have to meet certain government standards to ensure they are flexible and have a limit on annual management charges (*for example a cap of 1.5% for policies issued after April 2005 for the first ten years and 1% thereafter*). Furthermore, the UK government will cap auto-enrolment pension charges at 0.75% from April 2015. In **RO** legislation provides that administrative costs are capped at 5% from contributions and 0.2% from net assets. These methods mitigate the impact of costs on members and the downside of choosing an inappropriate investment option. Capping costs, however, does open the issue of dealing with the possible phenomenon of **ceiling convergence** that would lead to lower competition, against the interest of members.

Legal investment restrictions – in **SK**, **PL** and **RO** legislation limits from a qualitative and quantitative point of view investments opportunities to ensure diversification and / or a balanced level of risk. In **UK** certain employer related investments are limited or not permitted. These methods mitigate the level of inappropriate risk that a member may expose him/her to.

However, considering that even the IORP Directive addresses some investment rules, including a few quantitative restrictions, this is a rather a general issue and not specifically limited to the MS that have mentioned these restrictions in the questionnaire.

Guarantees as a legal requirement – the default option in **IT** and the conservative funds from the lifecycling set of funds in **SI** have a guarantee. All DC schemes offered by BE employers are subject to a legal minimum guaranteed return (*3,25% on ER contributions and 3,75% on EE contributions*), and DC schemes offered to self-employed persons are subject to a legal minimum guaranteed return of 0%. **Guarantees diminish the level of risk that members face, but this may come at the expense of a lesser net return.**

Supervision based on the prudent person principle – this particular subject is especially addressed by 3 MS and is also specified in the IORP Directive. In **LU**, the supervisory department assesses whether the assets are invested in assets that are too risky (*applying the prudent person principle*). In **NL**, the investment risk should diminish when the pension date approaches, whereas the investment strategy should be prudent and in the interest of the participant. **IE** also mentions that alongside investment regulations, prudent person principles are applied to IORPs investment holdings.

Requiring an appropriate governance structure and providing guidance for entities involved in the investment decision making process – The national authority of **UK** provides a high level of guidance on trustees' investment governance duties. For example there is a legal requirement that trustees must take investment advice from an appropriately qualified person, and they need to review the "Statement of Investment Principles" whenever there is a change in circumstance or

at least in three years. The DC code⁴³ in **UK** also gives guidance on default scheme design strategy for employers. These requirements and elements of guidance reduce the possibility that the investment strategy will deviate significantly from the risk and return objectives of members.

4.2.2. Information

Another frequent method addressed by national supervisors in order to mitigate perceived risks is managing information provision. Even so, this is a controversial solution, given the level of accessibility of information and the capacity of members to understand it and interpret it properly in order to make good investment decisions.

Actively provided information – information is actively provided and available at request in several MS (**RO, SI, UK, IT, PT** and **LU**). Such information may vary between investment strategy documents, provisions and data on costs, rewards and risks. By actively providing information, it is ensured that information reaches its destination.

Standardised comparable information – one way to ease interpretation of information and comparability among investment options is provision of standardised information. Information is standardised and comparable in some MS, such as **IT, SK** and **RO**. In **SK** and **RO** most of the content, scope and format of information is determined by law and verified by the supervisor, attaining the scope of comparability among investment options.

Information technology – information provided by the Australian Supervisor⁴⁴ indicates that following the recent Stronger Super Reforms there has been an initial focus on information provision for the default product, MySuper (My Super schemes – default schemes offered by the industry, corporate and retail funds) with further consultation taking place for schemes where members can choose (in this latter context there are frequently financial advisors/financial planners and accountants giving generic, and in some cases, individual advice). The Stronger Super Reforms introduced the requirements for “**MySuper product dashboard**” to provide members with key information about their pension product. The dashboard is required to show the actual return, the return target for the next 10 years and graphically shows the difference between the two. There is also a measure of investment risk using a standard risk measure developed by industry representatives showing the expected number of years (*out of 20*) when negative returns may be expected. There must also be a statement of fees and other costs. ASIC (the conduct-of-business authority from the Australian twin peak model) investigates the effectiveness of the dashboard by conducting interviews and involving their online community. They search for cues referring to: aesthetics, availability in annual statements, if figures available in comparison websites (*like for insurances*), independent source of information, providing reference points, calculation tools (*MoneySmart Retirement Planner*), trust issues. ASIC also has in place a number of other disclosure requirements for pension funds including requirements relating to Product Disclosure Statements, fee and cost disclosure requirements, and executive remuneration. One big concern on the Australian supervisor and something they want to target and diminish is the general concern of people not being involved in retirement planning like they should.

⁴³ www.thepensionsregulator.gov.uk/docs/code-13.pdf;

⁴⁴ On the 10th June 2014, the OPC subgroup and EIOPA had an interview with a representative of the Australian Prudential Regulation Authority.

4.2.3. Distribution

One additional area that supervision may focus on is the distribution of occupational DC pension schemes, although this subject is less addressed by national authorities compared to the above.

Duty of care – one element that the Dutch supervisory authority focuses on is the applicability of the legal duty of care. Entities involved in designing and implementing the investment strategy, having a fiduciary duty toward members and having a position of trust, are supposed to base their actions on a clear profile of the member, they have to give advice to members, and they have to periodically monitor investment to market and profile changes. The authority has issued guidance on how duty of care rules may be applied in proactively ("Visie op open norm zorgplicht"), given the "open" character of the Dutch Pension legislation. In this manner, pension schemes can better address the particular needs and objectives of members⁴⁵.

Guidance to limit number of options – the Dutch national authority manifests the direct concern connected to the number of investment options (*if being too large*) and the negative impact that this may have on the member's capacity to make investment options in the member's best interest. As such, the supervisor advises IORPs to keep a limited number of available investment choices.

4.2.4. The default

A complex, yet direct approach of addressing a large number of the risks that supervisors experience or envisage at the level of how an investment strategy will address the needs and objectives of members, is to remove the initial choices that members may have: the default strategy.

This strategy is applicable in several MS as the dominant strategy or as coexisting with more flexible architectures where members do have choices to make from an initial standing. The default clearly addresses the risk of enrolment and brings the important argument of cost effectiveness, giving in the same time the possibility that a member may opt out and pursue his own investment decisions forward. However, important issues still remain, as the argument of inertia and the suitability of the default investment strategy to a member's risk and return profile.

Based on insight gained from the Australian Supervisor, the recent **Financial System Inquiry** has made recommendations designed to improve the operational efficiency of the default fund process and improve the quality of financial advice. The FSI has also focussed on the need to ensure cost control and sound governance of pension funds to ensure that they are delivering the desired outcome for fund members. Other measure to improve default outcomes include specific and measurable investment objectives (*including risk and return*), effective due diligence for selecting investments, appropriate measure to monitor performance, reviewing periodically the investment strategies, and a liquidity management plan.

In **UK** and several other EU MS, **the employer has a significant role in the investment strategy of the default**. Addressing this issue, the UK authority has developed a system of guidance for employers⁴⁶.

In **SI** legislation, auto enrolment is based on the age of the member: the younger the member is, the more risky is the fund automatically chosen for the member, unless he/she decides otherwise. This means that older members are automatically enrolled

46 www.thepensionsregulator.gov.uk/doc-library/pension-guides.aspx

to the least risky fund and he/she cannot choose to invest in the fund with more risky investment policy. The IORP determines the age groups to which each of three funds is intended.

4.3. What information do supervisors use

National authorities indicated some examples of the main pieces of information and activities they use in order to pursue supervision of the investment strategies. Among the information, documents and activities they use in their supervisory activities, the following was mentioned:

- a statement of investment policy principles in order to review the investment strategies (in **AT, BE, ES, HR, PL, PT, SE, SK, IT, FI** and **RO**);
- in **SI** the supervisor looks at the pension fund rules which are required to take up information about the risks and risk mitigation techniques;
- in **PL** annual information is received about the full structure of the asset portfolio (*this is a part of annual, audited, financial statements*), half yearly information about every asset >1% of fund's assets (*non-audited*), quarterly information about full structure of asset portfolio (*non-audited*), as well as ongoing information about performance and financial standing (*in case an IORP breaches rules of investment performance*);
- in **RO**, weekly and monthly information is received about investment portfolios, as well as monthly accounting data, half year reporting non-audited financial statements and yearly audited financial statements; monthly information about the asset structure of portfolios is also available in **SK**;
- in **PL, RO, SK** and **NL** there are onsite and / or offsite inspections;
- in **NL** an important element of supervision is self-assessments;
- in **NL** there is legislation which determines that DC-pension products have to be designed according to "product oversight and distribution". This means the producer of the product has to make sure the product is well balanced and designed in the interest of the consumer;
- the supervisor in **PL** and **RO** is entitled to request information from the fund, society and depository;
- In **PL**, if entities fail to eliminate irregularities in a given timeline, or in case of a blatant infringement, the supervisor can impose a fine up to PLN 500,000 on the society, depository or third party in which the fund or society vested the performance of certain tasks;
- **NL** issues guidelines (as well as **SE**), makes reports and sends newsletters.

However, it is important to stress that this is not an exhaustive list and the information above is developed under the limitations of the data provided through the mapping exercise.

5. Conclusion

This report examines the extent to which investment decisions and choices are available to EU/EEA members of occupational DC schemes, who mainly come under the scope of the IORP Directive⁴⁷.

Chapter 2 outlines the theoretical framework for optimal investment decisions and then explores relevant behavioural research insights to help EIOPA better understand:

- a) why investment decisions may be partly or fully made on behalf of occupational DC scheme members and;
- b) the different models of "choice architecture" available in Europe to support effective investment decisions in occupational DC schemes.

In chapter 3, information from 21 MS who took part in the survey was collated to provide a European map of "choice architecture" and help EIOPA identify the range of methods used across Europe to support members in their investment decisions.

Results from the mapping exercise set in Chapter 3 suggest that **investment governance, the default investment option and limiting the choice for investment options** (often combined with lifestyling) **are amongst the main instruments used to facilitate effective investment decisions**, albeit with variations over the level and/or nature of member choice across the 21 participating MS.

At European level, results indicate that investment governance prevails and is commonly used to support effective investment decisions. Member choice is not universally available across European occupational DC schemes. Moreover, where members can make choices, these tend to be limited to a few options (addressing choice overload) and often feature the possibility of a default investment option (i.e. allowing for passive choice and harnessing members' inertia).

Chapter 4 extracts from the mapping exercise the main risks perceived by national authorities regarding the investment process for occupational DC pension schemes, and the mitigation techniques that would address these risks.

Findings from mapping the "choice architecture"

A majority of participating MS (16 out of 21) have occupational DC schemes where members have no choice. Occupational DC schemes offering a certain level of choices for members (initially and on-going) feature in half of the participating MS (12 out of 21 MS). Having in mind the extent of members' choices, there are very few exceptional cases where scheme members can completely design their own investment strategy through securities picking⁴⁸.

This suggests **the importance of investment governance in a European context** - through governance aiming to reveal the extent to which, in the occupational DC

⁴⁷ We are not able to answer exactly only for the schemes under the scope of the IORP Directive, since we also cover MS where schemes that are not under the direct scope have filled out the questionnaire (e.g. **RO, NO**, other), or they filled it out both for both schemes under the scope of the IORP Directive and other schemes (e.g. **IE**, other).

⁴⁸ Securities picking is not a common practice among MS, and only sparsely exists in **IE, NL** and **UK**.

schemes from the 21 surveyed MS, other entities are responsible for designing the investment strategy on behalf of members (*with some variations over what may or may not be already predetermined in national law e.g. default investment option*).

Evidence from behavioural finance literature shows that default investment options are crucial as members tend to postpone decisions. The mapping exercise suggests that **in most MS where member choice applies, a default investment option tends to be available** (9 out of 12). In the remaining 3 MS (**SK, IT and RO**), members always have to make active choices.

Also, where member choice applies, **the most common decision members have to make consists of selecting between a limited set** (*mostly up to a maximum of 5*) **of investment options** (8 out of 12 MS). In 4 out of 12 MS, members can additionally choose between IORPs (**IT, SI, PT, and RO**⁴⁹). Literature shows that a limited number of choices would prove favourable in discouraging the effect of facing too many choices for members (*choice overload*)

Looking at **on-going investment decisions** where member choice is available, results indicate that in 5 out of 12 MS, **members have to actively adjust the riskiness of the investment strategy according to the time horizon**. In other MS, the time horizon might be automatically taken into account by the IORP and/ or other entities, or might not be considered.

The limited set of available options, in MS where members can allocate among multiple investment options (8 out of 12), and the fact that member security picking is an uncommon practice at European level, indicates that **ensuring a diversified portfolio is not an issue that needs to be addressed by members**.

Risks perceived by national authorities

As part of the mapping exercise, national supervisors were asked about the potential risks associated with the various forms of "choice architecture" and methods of addressing these risks through the support provided by professional entities involved in occupational DC pension schemes.

In occupational DC schemes where **members have no choices**, supervisors highlighted the **potential unsuitability of the investment strategy** to address members' risk and return profiles.

Looking at **default investment options**, national authorities highlighted the risk of **unsuitability of the default investment option** which could be too general, and hence failing to meet varying return and risk profiles for different segments⁵⁰. Some concerns were also raised over **on-going member disengagement** whereby members are unlikely to monitor the suitability of the default investment option over time⁵¹ (*especially as and when the IORP changes the investment strategy of the default option*).

Although not outlined by national supervisors, the behavioural finance literature⁵² suggests that members may implicitly (and erroneously) interpret the **default investment option as a "recommendation" or a "reference"**.

Looking at the entities involved in the investment decision-making process, findings from the mapping exercise corroborate with previous EIOPA work, which suggests

49 As previously mentioned, these are pension fund managers, since there are no IORPs currently in RO.

50 The current report did not look specifically at the suitability of investment strategies in terms of "Value for Money" (costs) to members of occupational DC schemes, although it did mention the impact of costs. Regarding this topic, in 2014 EIOPA's initiated within the OPC a project on "Costs and Charges".

51 Although members can request SIPP unlikely they will request this document as being too technical.

52 Choi et al. (2009)

that **the involvement of the employer in determining the default investment option** (*in this mapping exercise observed in 8 out of 10 MS*). To a lesser extent, employer involvement was also identified in the development of a) other non-default investment options (6 out of 12 MS) and; b) the investment strategy of occupational DC schemes where there is no member choice (6 out of 16). However the question that arises is whether the employer has sufficient support, advice and information to base their investment decisions on.

Where members of occupational DC schemes are required to make limited active choice, national supervisors indicated that members' **behavioural limitations may persist over time**. Members may still find decisions too complex, face too many choices which are difficult to compare (*but also difficult for authorities to supervise*), display signs of loss aversion or use simple rules of thumb leading them to making suboptimal investment decisions.

Finally, some concerns were raised over **some entities** providing support to members as the former **may not act in the best interest of members**.

Figure 3 provides a non-exhaustive list for European policy-makers and supervisors of potential advantages and considerations associated with different models of choice architecture (*i.e. investment governance⁵³, default investment options and reducing choice*) in addition to information provision (*e.g. standardised, comparable information, support, decision making aid*).

Considerations may include looking at:

- the trade-off between the costs of collecting member information and gaining better understanding of the target group/members (*e.g. on-going behavioural biases, objectives, liquidity needs and choices, if any, during the decumulation phase*);
- any risk of "default endorsement effect" where members may implicitly interpret the default (especially if set in the law) as an "ideal" or a "recommendation";
- other potential framing effects e.g. position of the default investment option amongst other investment options.

Addressing perceived risks by supporting members

IORPs and/or other entities are supporting members of occupational DC schemes, whether it is to ensure suitable investment strategies (including a suitable default investment alternative), or to provide support to members' decision-making (through information provision and/or personal advice).

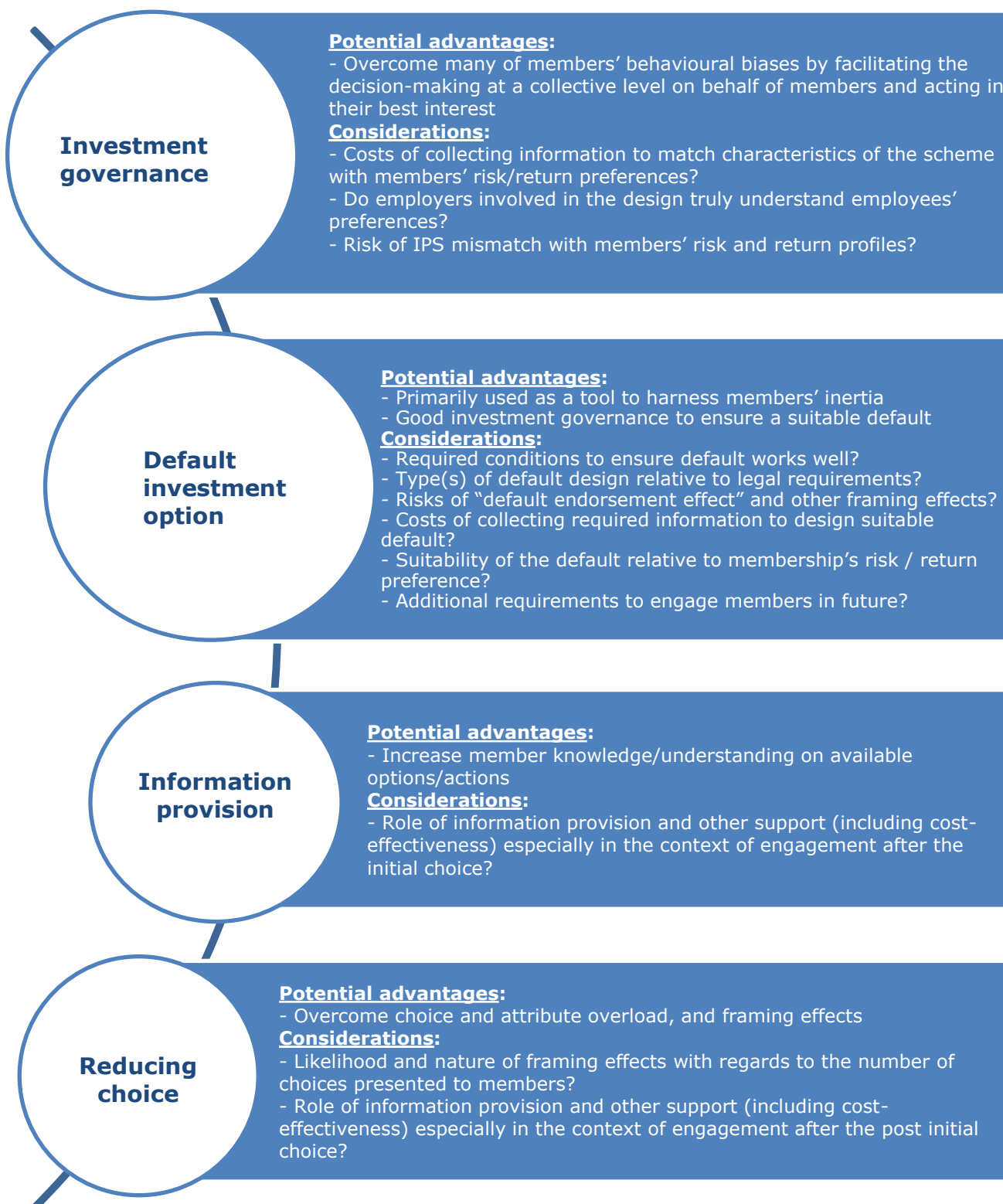
Overall, the **focus seems to lie more on the suitability of the investment strategy, as the main and general risk perceived, relative to member support**. In 11 out of 16 MS where there are schemes where members have no choice, IORPs take into account the suitability of the investment strategy. Where member choice is available, 6 out of 9 MS reported that suitability of default investment option is taken into account. A further 7 out of 12 MS made a similar observation for IORPs offering a limited set of investment options.

Whilst in 7 out of 12 MS (*where there is choice*) support may be available to members, only 5 (out of 12) reported that **information is provided to compare different options in terms of costs, risks and rewards**. Similarly, automated

⁵³ Defined as taking decisions collectively on behalf of members and acting in their best interest.

decision tools and personal assistance are available to members only in a few MS (5 out of 12).

Figure 3 Summary of common advantages and considerations stemming from the choice architecture



Investment Governance and the Suitability of investment strategy

The risks identified by supervisors reinforce the previous finding on the importance of investment governance within the European map of choice architecture.

From a European legislative perspective, there are currently two articles within the IORP Directive which put legal requirements on the investment governance of IORPs:

- **Article 18 “Investment rules”** requires IORPs to invest in accordance with the “prudent person” rule which, amongst other things, means that assets are “to be invested in the best interests of members and beneficiaries” and in a manner to “ensure the security, quality, liquidity and profitability of the portfolio as a whole”. It also limits the proportion of assets that can be invested in the sponsoring undertaking.
- **Article 12 “Statement of Investment Policy Principles” (SIPP)** requires IORPs to prepare at least every three years – or earlier if there is a significant change in the investment policy - a written statement which “contains, at least, such matters as the investment risk measurement methods, the risk-management processes implemented and the strategic asset allocation with respect to the nature and duration of pension liabilities”.

The closest equivalent of the SIPP that is specifically mentioned in the theoretical background of this report is the IPS. As mentioned initially in the theoretical section of chapter 2, not only there should ideally be a correlation between the IPS and member’s objectives but the consistency of how the IPS is reflected in the asset allocation would be an important issue. Based on the previous, some national supervisors (8 out of 21) have taken the step of directing part of their resources and activities in using investment policy principles in reviewing the implemented investment strategies.

However important this document may be in the investment process, one has to think about the implications and relevance of making this statement accessible to the average member in a pension scheme. As previously mentioned, members are not “Homo Economicus” and having such a technical document at their disposal may simply prove to be unnecessary. Moreover, one has to think about the impact on costs and the efficiency of making the investment policy principles universally available, and the costs that might be further heightened by possible methods of surpassing the bounded rationality of members. In this regard, the IPS would become more relevant and important to **the competent and technical investment decision makers, which, in most cases are not the members**, but the IORPs and other relevant entities (*such as the employers*).

Whilst **at European level**, Recital 31 of the IORP Directive⁵⁴ states that “compliance with the ‘prudent person’ rule requires an investment policy geared to the membership structure of the individual institution for occupational retirement provision”, **at national level**, some authorities have acknowledged the need to go

⁵⁴ “Institutions are very long-term investors. Redemption of the assets held by these institutions cannot, in general, be made for any purpose other than providing retirement benefits. Furthermore, in order to protect adequately the rights of members and beneficiaries, institutions should be able to opt for an asset allocation that suits the precise nature and duration of their liabilities. These aspects call for efficient supervision and an approach towards investment rules allowing institutions sufficient flexibility to decide on the most secure and efficient investment policy and obliging them to act prudently. Compliance with the ‘prudent person’ rule therefore requires an investment policy geared to the membership structure of the individual institution for occupational retirement provision.”

beyond the IORP directive, for instance, by issuing guidelines on investment strategies to ensure that IORPs' investment strategies meet the best interest of members:

- in **UK**, the national authority provides a high level of guidance on trustees' investment governance duties, including the need to review the "Statement of Investment Principles" and take advice from qualified entities regarding investment activities whenever necessary. This guidance of governance has the role of better aligning the interests of members and the entities that are making investment decisions on their behalf.
- in **NL**, guidance from the supervisor aims at eliminating the behavioural response of members facing too many choices, by encouraging IORPs to develop only a limited number of investment choices that will be available to its members.
- some national authorities (e.g. **UK**) went further and have also considered and implemented guidelines targeted at employers to account for their involvement in the IORP's investment decision making⁵⁵.

In light of the above, there are several areas of work which EIOPA may take forward and consider exploring in future regarding investment governance in occupational DC pension schemes.

1) The report findings suggest there is room to improve the link between the Statement of Investment Policy Principles (SIPP), as currently described in the IORP Directive, and the characteristics of the target group/membership. Consequently, in 2015 EIOPA will conduct a peer review of article 12 of the IORP Directive. The review's terms of reference should build on relevant findings presented here with a view to identify best practice as well as make concrete recommendations for strengthening the investment governance of IORPs in occupational DC schemes through improved supervisory convergence⁵⁶. The peer review will also consider information disclosure of the SIPP which is referred in both articles 11 and 13 of the IORP Directive.

There is already evidence of a supervisory focus on IORPs' fiduciary duty⁵⁷ in the context of the IPS/SIPP. For instance, in **NL** the supervisory authority has put requirements on parties involved in designing and implementing the investment strategy to base their actions on a clear profile of the member, give advice to members and periodically monitor the investment strategy to market and profile changes. The authority has also issued guidance on how duty of care rules may be applied ("*Visie op open norm zorgplicht*"). In the **UK**, some market participants including the National Employment Savings Trust (NEST), provide members in communications with clear explanations in the event of an investment loss, members should receive clear explanations of what had happened to "their money", as opposed to using just technical descriptions of investment strategies in communication to members. The communication intends to provide reassurance about what is being done to prevent future losses and to recoup the amount that had been lost⁵⁸.

55 The Pension Regulator in UK does provide guidance to employers, in order to support them with regard to the investment strategy.

56 In addition, EIOPA will conduct a pension stress test on IORPs. In the context of occupational DC schemes, the stress test will assess the impact of adverse scenarios on members' future retirement benefits as well as the nature of and trends in IORPs' investment policy to analyse investment behaviour during the crisis.

57 In a large amount of situations, most of the investment decisions are taken by different entities in the name of members of occupational DC schemes. However, these entities, having a position of trust and a responsibility of acting in the best interest of members, have to base all investment decisions on a more or less specific profile of the member. In theory this process would be consistently applied by building an asset allocation within the confines of an investment policy statement. The investment policy statement would then be periodically revised based on changing circumstances of the market and / or the risk and reward objectives of the members.

58 <https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/understanding-reactions-to-volatility-and-loss,PDF.pdf>

Moreover, it should also be personalised, for instance, in the form of more helpful statements.

2) Subject to final approval of the IORPII Directive, EIOPA may consider on how best to support national competent authorities with implementing some of the Directive's new proposals for occupational DC pension schemes, where needed. For instance, EIOPA could look at potentially **developing some guidance for IORPs on how to help them mitigate any future risks** (*for members of occupational DC schemes*) **of unsuitable investment strategy and/or investment options** (*including default option*).

The theoretical framework set in Chapter 2 outlined that establishing a member's risk and return profile is a pre-requisite to developing a suitable investment strategy. Findings from the survey indicate that, on the one hand, the **time horizon** is one of the most common characteristics taken into account to determine both the investment strategy and investment options, being addressed either through lifestyling practices or the development of multiple investment options suitable for different target groups in occupational DC pension schemes. Even so, some research⁵⁹ suggests that lifestyling may not necessarily benefit the average member⁶⁰. On the other hand, one of the least addressed issues, based on the information extracted from the answers provided by MS to the questionnaire, is the **distribution** of pension schemes.

One possible aim of further considerations could be how investment strategies can be better tailored to the characteristics of the target group, and how entities (other than the IORP) are involved in the determination of the investment strategy in occupational DC pension schemes.

Taken matter one step further, future work considerations on the suitability of investment strategies and investment options available to members in occupational DC pension schemes should be placed in the context of decumulation practices. Building on EIOPA's latest fact findings on decumulation practices, further analysis on the use of lifestyling and time labels could be also be considered. Moreover, EIOPA could take a similar approach to this report and map out the extent to which "choice architecture" is used in Europe to facilitate effective retirement income decisions and identify, where applicable, potential risks to supervising authorities and scheme members alike.

3) As part of undertaking and exploring further work, EIOPA could, where applicable, learn from the experience and **insights gained from existing European legislation and other initiatives in the field of investments at national and European level.**

Information provision and helping members make investment decisions

Whilst **information provision is not a panacea** to address individuals' bounded rationality in the context of investment decision-making, this project highlighted the importance of on-going member engagement (*after the initial choice –whether passive or active*). Disengaged members give rise to potential choices of unsuitable investment strategies and/or investment options to members over time.

59 Booth et al. (2000); Hibbert & Mowbray (2002) and Blake et al. (2007)

60 Whilst avoiding some of the worst potential individual outcomes, lifestyling strategies do this by reducing the average value of the pension. The reduction in average value is found to be greater the longer the lifestyle switch begins in years from retirement. For a longer discussion on the utility of lifestyling (lifecycle funds) please refer to the appendix (A).

In 6 out of 21 MS where information is either actively provided or available on request, often its content remains too technical and complex to addressing the average pension scheme member's behavioural limitations⁶¹. Generally, people suffer from inertia, lack of willpower, are easily overwhelmed by information provision, and, in consequence, make decisions based on rules of thumb.

In some MS (**SK, IT and RO**), the method chosen to partly address the potential use of **information is by provision of it in a standardised form**. In this case members may find it easier to interpret and mostly compare investment options in order to choose the one that best fits their profile.

Transparent and standardised information in occupational DC pension schemes is only one piece of the conundrum as it does not necessarily address members' difficulties with comparing products and services and/or translating what the information means in terms of next steps or actions they need to take. With the growing use of online communications, there is an opportunity to further explore how digital services and web-based decision tools can be leveraged to potentially improve information transparency, decision-making and ultimately member engagement in occupational DC pension schemes.

Generally speaking, good information provision has behavioural purposes, answers key questions, is personalised and engaging, restricts the number of topics, uses reference points and is comprehensible to its target audience (EIOPA, 2013). Additionally, there is evidence suggesting that **interactive automated tools can have a positive impact on actual decision-making** (Hastings et al., 2013⁶²; Dellaert & Haubl, 2012⁶³) that could apply to occupational DC pension schemes.

Policymakers and their advisors aim to improve standard information, for instance by setting up a Key Information Document or Pension Benefit Statement. Supervisors will only partly succeed in ensuring that this information can be optimally used by members. Looking in the wider area of financial services, there is an array of third party organisations - whether not-for-profit (*e.g. consumer organisations*) or private⁶⁴ that have built knowledge and expertise in developing interactive tools that could be used to enable and encourage members to compare products and services, financial institutions, and/or assist their decision-making in a more engaging way. In the context of insurance, EIOPA (2014) has identified and published good practices on comparative websites: The development of interactive automated decision tools (*e.g. apps for smartphones and tablets*) could not only support scheme members in their investment decisions, but also increase feedback mechanisms to occupational DC schemes – potentially helping the latter better address members' objectives and improve the their suitability for the target group of members. However, it is important to stress that, the use of digital comparison and/or decision tools – inspired from or provided by third parties – does not mean granting access to privileged and sensitive member and/or scheme information.

For further considerations, EIOPA's joint CCPFI⁶⁵-OPC work stream on pension information to members and beneficiaries should look at gaining a better understanding of the behavioural biases associated with information provision (*e.g.*

61 Such information can cover investment strategy documents, and provisions and data on costs, rewards and risks;

62 Hastings et al. (2013)

63 Dellaert & Häubl (2012)

64 In general terms, this is an approach to which UK is committed, given the enhanced comparability that can be expected regarding the market and price.

65 Committee on Consumer Protection and Financial Innovation.

framing effects) and potential emotional responses to pension information⁶⁶ - with a view to identifying effective methods for structuring pension information in a comprehensible, simplified, standardised and more comparable manner (e.g. *comparability between investment options*).

The role of the employer in developing suitable investment strategies

Whilst the current scope of the IORP Directive does not cover employers specifically, MS' responses suggest that in case of occupational DC pension schemes they play an important role in the scheme's investment strategy, especially in case of the default investment option (in 8 out of 10 MS). As a result, the question of the employer role and influence in occupational DC pension schemes deserve further considerations.

Making investment decisions in the name of scheme members of occupational DC schemes implies a position of competence that points to the important question of what are the employers' skills in financial and investment management, how often they resort to external investment advice and how much guidance do they receive regarding these aspects. Some MS' national authorities have already considered the governance impact of the involvement of employers in investment decision making, and have issued guidelines in this respect (such as the **UK**).

As a starting point for further considerations, EIOPA's CCPFI will initiate a new project, part of its 2015 mandate, to look at the employer role in the context of pension information and the tools they use to communicate with employees on pension matters in the case of occupational DC schemes.

⁶⁶ Qualitative research commissioned to inform the investment strategy for a new DC occupational pension scheme in the UK found evidence of emotional reactions to a pension loss (even if the latter is temporary). It concluded that providing and presenting information about pension performance and the possibility of interim loss is one way to mitigating loss avoidance reactions. In addition, in the event of a loss, members should receive clear explanations of what had happened to "their money", as opposed to using technical descriptions of investment strategies. The communication should also provide reassurance about what is being done to prevent future losses and to recoup the amount that had been lost. It should also be personalised, for instance, in the form of more helpful statements.

APPENDIX A – Default funds

Definitions (based on IOPS reference)

Default funds tend to fall into the following categories:

Conservative fund – as default funds aim to serve those less able or willing to engage with their pension fund, they are often designed to be conservative funds, which expose members to little risk. This means that they are mostly/only exposed to low risk assets such as bonds, with very few or no equity investments. The challenge for these funds is whether too little risk is being taken and whether they can generate adequate retirement incomes.

Balanced fund – these are funds which automatically rebalance their holdings towards a target asset mix that remains constant over time. For example, a fund might target a 60%-40% mix of stocks and bonds; periodically, the fund sells some of the holdings of the asset class that has outperformed over the period, and uses the proceeds to invest in the asset class that has underperformed as to keep the mix of stocks and bonds in the portfolio on target (Viceira, 2010).

Lifecycle fund – these funds also rebalance automatically towards a target asset mix. However, this target asset mix does not stay constant over time; instead it becomes increasingly conservative over time until it reaches a certain target date, at which point the target asset mix remains constant.

For and against lifecycle funds

Viceira (2010) supports the use of lifecycle funds as defaults, arguing that: “under plausible characterizations of labour and income uncertainty, human capital arguments provide support for the age-based asset allocation strategies that life-cycle funds follow. It also provides a rationale for adopting these funds as default investment choices in pension plans.” In addition to human capital arguments, the mean-reversion behaviour of equity returns is also mentioned as a reason for using life-cycle funds as default investment options.

Meanwhile, Booth and Yaboubov (2000) discuss how, as lifecycle funds entail more risk than may be realized (*such as to falling interest rates, rising annuity prices, inflation, duration mismatch etc.*), a balanced fund (*i.e. diversified portfolio of real assets*) may offer better protection (*providing diversification and interest rate protection*).

Bodie and Treussard (2007) also argue that deterministic target date funds are optimal for some investors, but not for others, with suitability depending on the investor’s risk aversion and human capital, whilst Cairns, Blake and Dowd (2009) argue that deterministic lifecycle strategies, although easy to understand and implement, can be highly suboptimal, since they do not take into account either the degree of risk aversion or the correlation over time between the plan member's salary and the stock market.

APPENDIX B – Member States that took part in the mapping exercise

NO.	ABBREVIATION	MEMBER STATE FROM MAPPING EXERCISE
1.	AT	Austria
2.	BE	Belgium
3.	BG	Bulgaria
4.	EL	Greece
5.	ES	Spain
6.	FI	Finland
7.	HU	Hungary
8.	HR	Croatia
9.	IE	Ireland
10.	IT	Italy
11.	LU	Luxembourg
12.	LT	Lithuania
13.	NL	The Netherlands
14.	NO	Norway
15.	PL	Poland
16.	PT	Portugal
17.	RO	Romania
18.	SE	Sweden
19.	SI	Slovenia
20.	SK	Slovakia
21.	UK	The United Kingdom

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