

Transparency of private “Riester” and “basic” pension products BMF Research Project 7/09

An obvious problem for the comparison of private pension products is the long investment horizon which usually extends over several decades. Return forecasts for such a long time horizon are generally unreliable. Further substantial problems in the assessment of private pension products are different cost calculations and risk-return profiles, particularly with respect to guarantees for minimum returns, minimum durations of guaranteed annuity, payback of contributions in case of death during the payment period, etc. A number of different information duties already exist for all product categories that are currently subsidized by the government. However, these regulations are usually not harmonized. Therefore, current product offerings often contain a lot of different information on numerous pages, leading to an information overflow on the side of pension savers. This is one reason why private old-age pension products are often assessed as costly and not transparent. In this study recommendations for improving the transparency of private pension products are developed, based on desktop research as well as extensive surveys in the financial industry and workshops with suppliers and consumers.

Regarding product characteristics, there are two main levers to improve transparency: cost transparency and transparency of expected returns and risk. For the numerous cost elements transparency could be enhanced by making aggregate key indicators compulsory. These could be a reduction in yield figure (accounting for all cost elements), covering the stage of paying in, and an expense ratio for the stage of annuity payments. For expected returns and risk, transparency is more difficult to achieve. Since technical standards for stochastic return simulations of pension products are currently being developed (but not yet available), an open model should be implemented which allows the integration of evolving simulation standards at a later point of time. We recommend a scheme with three levels, beginning with mandatory core information on the first level, additional mandatory information on the second level, and voluntary but highly standardized information on a third level. This “pyramid model” offers a basic orientation for the superficial reader while at the same time providing more detailed information for the interested investor.

On the first level information should be given on core data such as the category of product (e.g., annuity product, mutual funds saving plan, bank savings plan, or other product). The most important risks and guarantees should also be described. For costs, the above described aggregate key indicators should be provided.

The second level should provide standardized information on the risk-return profile and the suitability of the product for different groups of investors. Here a two-dimensional presentation is recommended, referring to the risk preferences and the age of the investor. This two-dimensional scheme circumvents the disadvantages of a simple red-yellow-green classification (where red always is a negative signal) and allows for a differentiated positioning of each product along these two dimensions. Particularly for mutual funds based products, information on the asset allocation should be added.

The third level should provide further standardized information on the risk return profile on a voluntary basis if reliable results of stochastic simulations are available. As a presentation standard, we suggest graphical illustrations of frequency distributions or confidence intervals. Additional information can be provided by a downside risk indicator for the probability to fall short of an average annual return of 2 percent p.a., which is the maximum inflation rate that is tolerated by the European Central Bank. As long as stochastic simulation standards are not available, model calculations with standardized interest rates can be provided instead.

The study contains a proposal for a complete product information leaflet, containing the information for all three levels on three clearly structured pages. The report also suggests regulatory measures to ensure that information duties are fulfilled in time and that the provided information is correct. Finally, we recommend requiring the same mandatory information for basic pension products (“Rürup” contracts) as for “Riester” pensions.