

26th Regime

Making the 26th regime, an attractive option. Pensions as a case study

I. The Commission White Paper calls for further work on the concept

Eurofi pioneered the first studies of the 26th Regime in 2003¹. Following these analyses and the research done by the European Round Table for Financial Services (EFR), the European Commission consulted the market, via the Green Paper on Financial Services Policy (2005 - 2010), about the desirability of exploring the 26th Regime, notably by means of a feasibility study. In the White Paper on Financial Services Policy (2005-2010), the Commission set out its reading of the responses to the consultation, which, in its words, showed **widespread scepticism**. Accordingly, it called on the promoters of this new approach to "explain their ideas and the legal and practical feasibility and advantages of such optional instruments in more detail".

We have written this summary from that perspective, and also to complement the EFR's work. In December 2005, the EFR issued a paper titled "Pan-European Pension Plans - deepening the concept" in response to a request from the European Commission.

In particular, **we endeavour to clarify** the definition of the 26th Regime and explain how it will contribute to European integration. We also list the main consumer protection issues arising from the 26th Regime and describe its links with Member States' civil law.

II. Definition of the 26th Regime

A careful analysis of responses to the Commission's consultation shows the need for an initial definition of the 26th Regime. Many of the respondents' queries or objections stem from assumptions about the scope or operation of such a system. By addressing these objections, it has also been possible to stabilise the content of the 26th Regime and set it out in greater detail.

Eurofi therefore offers the following definition as a basis for discussing and fine-tuning the concept at European level.

What is the 26th Regime?

1. The 26th Regime is an **optional pan-European body of rules (scheme) sufficient to permit the emergence of European products.**
2. This body of rules
 - **coexists with national laws;**
 - **is established by means of EU regulation in order to avoid any national discrepancies due to transposition work.**

¹ See, inter alia, the Eurofi memo published in March 2005 for our annual conference in Luxembourg

3. Key scheme attributes : this optional scheme
 - will permit the emergence of **European products** and services that would **compete with domestic** products and services;
 - is accessible to **multinational and local participants**;
 - is accessible for both **cross border and domestic activities**;
 - is a possible **alternative to avoid the implementation** of **multiple domestic schemes** but is not an additional mandatory scheme to implement.

4. Key characteristics: the body of rules should be
 - **simple, thus leaving maximum room for creativity** by financial institutions. This will promote robust competition and ensure that products are appealing;
 - **able to ensure that consumers are properly protected**, covering issues like the cooling-off period, consumer information (invoicing, performance, product description, potential risks, procedures for changing supplier), prudential rules and dispute settlement by courts in the consumer's country of residence;
 - designed such that these products are **eligible for the tax incentives** given to competing local products.

III. A body of flexible rules to allow competitive differentiation

1. **The 26th Regime does not give mandatory definitions of products**, which must then be adopted as-is and simply marketed by financial firms. On the contrary, the 26th Regime **should enable** firms firstly to design products that can be sold to **customers throughout the European Union** and secondly to **prepare products for specific commercial situations**. Broadly, the 26th Regime should enable competitive differentiation among suppliers in any given market. That is why it must allow market participants to be as creative as possible. And achieving that creativity demands a body of general, flexible rules. Allowing firms to be **creative** means that **product ranges will be tailored to customers' needs** and evolve over time. It also means that products can be tailored to the needs of specific customer segments. And it will **intensify competition**.

2. **Because the 26th Regime is optional, it will ensure fair competition among market participants**. At this stage it must be stressed that, under the 26th Regime, **competitive conditions will be the same for all participants**, whether domestic or cross-border. By contrast, harmonisation approaches based on mutual recognition (pure recognition, targeted harmonisation, etc.) automatically involve different obligations for market participants, who thus compete with each other on different commercial and industrial bases. Since the 26th Regime is optional, local and cross-border players are free to choose. Local firms can adopt the regime of the new entrant (i.e. the 26th Regime), while the new entrant may prefer to adopt the domestic regime applicable to other firms rather than the 26th Regime.

3. **Distribution will still be locally based.** The benefits of the 26th Regime stem from industrial synergies (product development, IT and administrative systems) and from the speed with which products can be rolled out across Europe. However, distribution will almost certainly remain at local level because of cultural and linguistic differences. The 26th Regime is not likely to boost cross-border marketing.
4. **For firms, the costs of implementing the 26th Regime will be progressive.** European harmonisation is expensive. With the deployment of a harmonised single regime, local or cross boarder suppliers throughout the EU, will have to apply the resulting provisions to their products and their marketing and production systems.

Under the 26th Regime approach, on the contrary, financial services suppliers can choose to stick with the local regime or adopt the new regime whenever timely, having regard to their investment capabilities and the obsolescence of their production systems. In particular, a firm that chooses to operate solely in one EU country because the local legal framework enables it to meet customer demand has no need to adopt the 26th Regime.

5. **A real opportunity to benefit from economies of scale.** Products prepared under the 26th Regime will be "European" in that they can be distributed anywhere in Europe. Accordingly, the 26th Regime, which allows similar products to be distributed in several markets, provides an opportunity for cost reductions, since the fixed costs involved in designing and processing products can be recouped on higher volumes. For asset management products, this broader commercial base will make it possible to capture the synergies that are likely to result from an increase in the size of investment funds (fixed costs will be lower and returns will be less volatile).

Even products that are aimed at specific customer segments or geographical areas and developed under the 26th Regime **are likely to benefit from standardised processing capabilities**. Since all these products are based on common legal provisions and governing factors such as regular communication with customers, supervisory and tax declarations, and so on, processing can be standardised through the 26th Regime, thus delivering significant cost savings.

6. **The 26th Regime is optional.** Given the specific features and fine-grained detail of national consumer protection rules, it would be wrong to think that a financial product can be dissociated from the legal system on which it is based. Customers do not therefore choose the legal framework of the product they purchase. That decision is made by firms, which prepare their product offering on the basis of the domestic regime or the 26th Regime, whichever enables them to respond best to customer demand and offers specific economic benefits. Customers make their choice on the basis of whether a product meets their needs and how it compares to other offerings. They therefore choose the regime only indirectly and implicitly.

IV. A model based on retirement savings to analyse the content of the 26th Regime

To determine the legal scope needed for a supplemental regime, it is necessary to examine its regulatory scope. This can be done through the models prepared by Eurofi and the EFR working group for the specific case of retirement savings.

The 26th Regime must cover four areas of legislation:

1. The definition of a **pan-European pension plan**, specifying its **social and economic purpose**, eligible customers, and possible suppliers. The definition will also establish **the plan's key components** – the main phases (vesting period, retirement age), the methods for paying contributions and pensions, the variety of products and the eligible risk profiles for retirement savings – to ensure that products based on these elements will contribute to the social and economic purpose;
2. **Regulatory and supervisory provisions**: protection of savings, technical reserves, regulatory capital requirements, supervision;
3. **Consumer protection measures**: procedures for advising consumers, mandatory contractual and pre-contractual disclosures (key pricing data, risk profiles, withdrawal rules and timeframes), periodic disclosures on performance or vested pension rights, arrangements for dismissing or changing suppliers, out-of-court settlement procedures, governance rules that protect investors' interests over time;
4. **Stipulations on relations with the tax authorities**: reporting formats and standards, tax incentives, etc. These factors should be common to all national authorities, but Member States can parameterise them so as to maintain fiscal autonomy. By contrast, in this area firms will use common production capabilities and software.

A substantial portion of single-market synergies stem from recurring regulatory processing, supervision and consumer protection. A political agreement on these key issues is therefore necessary

Product marketing functions will continue to be locally based, either for cultural reasons or because customers need advice (they want a supplier that is physically close, that speaks their language, etc.). As a result, **the main benefits** from Europe-wide products will stem from the pooling of software and from **recurring IT and administrative processing**. This will apply to factors such as the generation of pre-contractual and contractual information, repetitive processing of performance reports, measurement of the capital or annuities available upon retirement, tax base calculations, generation of disclosures to tax authorities, supervisory reporting data, etc. "Europeanisation" will make it possible to rationalise and concentrate non-commercial functions. And these synergies will be enhanced by those that should arise from the growth of **investment fund assets**, if this occurs.

Adopting 26th Regime legislation at European level requires agreement between Member States in the sensitive areas of consumer protection, supervisory approaches, and the chosen social and economic purpose.

The benefits of national tax incentives for 26th Regime products must stem from political agreement on the aims of the pan-European pension plan and its practical arrangements

To be successful, retirement savings products under the 26th Regime must also qualify for local tax incentives on supplementary pension schemes in many, if not all, EU Member States.

Is the fiscal autonomy of Member States a hurdle to 26th-regime savings vehicles? **Autonomy is vital** so that countries can adjust supplementary pension schemes to their specific needs and fiscal capabilities. Therefore, provided that Member States are satisfied with the definition, purpose and characteristics of the pan-European pension plan, as well as with measures on consumer protection and supervisory oversight, **there is no fundamental reason why they should not extend national tax incentives to products under the 26th Regime**, especially since it incorporates all the agreements embodied in the adoption of the corresponding directives. However, even if these European products under the 26th Regime do qualify for national tax incentives, differences in national tax practices generate additional costs for the industry and are therefore a hurdle to an integrated European market.

Differences in national tax practices are lessening the benefits of integration, regardless of how it is achieved

Tax practices vary widely across the EU, with diverse options (EET, ETE, TEE, etc.²), collection methods (at-source withholding, direct payment by the taxpayer) and incentives (reduction of the tax base, tax credits, etc.).

These discrepancies lessen from the benefits of integration, regardless of the method used to achieve harmonisation. Each country has to use a specific calculation and reporting tool. And in many cases, savings have to be invested in funds with particular national characteristics, since the method used to manage them has to be adapted to specific tax measures (e.g. taxation of short-term or long-term capital gains and income, different arrangements). EFR has therefore proposed that the suppliers of European pension schemes should set up a subfund for each specific tax measure.

In any case, the only way to overcome these problems is by seeking to harmonise tax practices, such as the choice of regime or collection and calculation methods, regardless of the integration method (mutual recognition, maximum harmonisation, etc.)

² Tax treatment that addresses each component on a retirement savings scheme, i.e. contributions to the scheme, income from invested savings, and pensions in payment. E stands for "exemption" and T for "taxation". Hence EET means that contributions and investment income are tax free and withdrawals are taxed. This is the most common regime in the EU.

V. Aside from harmonisation, transposition differences are the best argument for the 26th Regime

When preparing their models, both EFR and Eurofi took most of their 26th Regime proposals from directives that have already been adopted and, in some cases, transposed, including life insurance (Third Directive), occupational retirement provision and distance marketing directives. This has shown that the biggest hurdle to cross-border business lies in national differences in the transposition of EU directives. In life insurance, for example, the amount of space allocated to consumer information rules ranges from a half-page of general requirements (Belgium) to between seven and nine pages of detailed specifications for the same items (UK, Germany, etc.) – and this despite the adoption of the latest directive.

Ironically, the current barriers to cross-border marketing stem from national measures that embody the provisions of the harmonisation directives. The 26th Regime is therefore useful insofar as a high level of harmonisation – even at the detailed level – is needed to build a single market; it is also useful for restoring harmony when barriers to pan-European activity arise – as is often the case – because of transposition.

VI. From a technical perspective, a European regulation is the most appropriate implementation method, but national parliaments should be closely involved

The need for detailed harmonisation and, hence, the fewest possible differences at the transposition stage, also suggests that the 26th Regime should be implemented through a directly applicable regulation.

That said every effort must be made to involve national parliamentarians closely in the drafting of the regulation. The introduction of the 26th Regime must not create the impression that national elected representatives have been side-stepped, especially in the sensitive area of consumer protection. This is particularly important since the aim is for 26th Regime products to qualify for national tax incentives.

The example of retirement savings shows that a regulation of this sort is easy to draft because it basically consists of provisions set forth in directives which have already been adopted. All that remains is to fine-tune the practical details, which depend on the network of European regulators.

VII. Strengths and weaknesses of the chosen experimental field

Apart from a theoretical analysis of the technical, legal and political feasibility of the 26th Regime, full-scale testing is the only way to demonstrate the usefulness of this complementary method of integration. To learn practical lessons from this initial experiment, and to ensure that the economic and social goals can be successfully reached, it would be wise to limit the number of key issues addressed and to ensure that the economic scope is not too broad.

In this respect, the field of retirement savings is already vast. Some have suggested that the scope of the experiment should be restricted to Pillar III. But this would still

include two sensitive issues, namely qualifying for national tax incentives and determining a "reasonable" level of consumer protection. By contrast, Pillar II would raise fewer problems in terms of consumer protection. Pillar II products are designed for business-to-business applications; they are purchased by the human resources departments of industrial firms, under the close scrutiny of employee representative bodies. However, this would also involve working with a regime that covers social welfare law, thus adding a layer of legal complexity.

VIII. The 26th Regime and consumers

Judging from the reaction to the Commission's Green Paper, it would seem that consumers might be unsettled by the coexistence of the 26th Regime and the local regime.

It should once again be stressed that any feeling of unease would not be caused by having to choose between one or the other: a product is wedded to its legal regime, so consumers cannot select the regime of the product they want to purchase. In other words, they choose an investment vehicle, not a legal system.

And since the product's functionalities hinge on its regime, the consumer's decision is based on these rather than on a comparison of legal measures, including those pertaining to protection and information. A customer can gauge the merits of, say, a cooling-off period without being especially familiar with the underlying law.

However, the same customer may not be able to detect the differences in a product's characteristics that stem from differences in legal regimes. Eurofi therefore suggests that 26th Regime products should come with simple, clear explanations about their advantages and disadvantages compared with products based on the local regime. This approach should enable consumers to make well-informed decisions. It would also draw attention to things that they would not have identified when choosing among products governed solely by their national legislation. In this regard, the 26th Regime offers the opportunity to provide consumers with more detailed information and thus strengthen their confidence in financial products and services.

Consumers must also feel reassured – if only in terms of language – as regards litigated or non-litigated settlement procedures. Distributors should therefore introduce conciliation mechanisms that are accessible from the consumer's home country, and any disputes should be settled in that country.

It has been objected that an integrated market in financial products, and more specifically an approach based on the 26th Regime, would result in greater complexity as well as a surfeit of products and suppliers. This is doubtless the downside to the benefits of introducing fresh competition, spurred on by diversified product ranges. If this were the case, then that negative aspect would benefit local firms with an established reputation. New entrants would thus be forced to make greater efforts in order to clarify their offerings and make them easier to compare. And this would benefit consumers.

IX. Interaction with national civil legislation

One of the concerns about the 26th Regime is that it might interfere with Member States' civil legislation. Upon examination, much of this intrusion would appear to stem from the way that the legal beneficiaries of a contract would be treated in case of a major event affecting the contracting party (e.g. death, divorce, birth of a child).

Depending on the consumer's country of residence, such questions are governed either by the terms and conditions of the contract or by local law. In any event, financial firms are already familiar with such situations because they have to settle contracts under their domestic law in the case of customers who have changed their country of residence. Firms believe that the benefits of the 26th Regime will not be called into question by such sources of excess costs.

X. Proposals

The experiment with the 26th Regime in the field of retirement savings should be pursued. To that end, and to demonstrate the regime's benefits to European and national authorities, it would be useful to itemise those differences between pension products that are attributable to the transposition of EU directives. This once again highlights the relevance of the recommendation made by Sir Nigel Wicks at Eurofi Conference in March 2005. Sir Nigel proposed that a special unit be set up at DG Markt to monitor Member States' arrangements for transposing directives (Level 4 of the Lamfalussy Process).

It would also be helpful to describe differences in tax practices, to assess their negative impact on the integration process – regardless of the method chosen to reach that end – and to show that Member States can maintain fiscal autonomy while harmonising their tax practices.

In sum, the feasibility of the new approach can be demonstrated by preparing a draft regulation. Based on that document, which the EFR is due to release in the near future, representatives of consumers and savers must be mobilised and brought together. It will then be necessary to approach and inform the members of the Economic and Financial Committee and the main representatives of the Finance Commissions of National Parliaments in order to take account of reactions and get them on board. This is a vital precondition for initiating political momentum and reaching agreement at European level.

Eurofi contacts

Jean-Marie Andrès, Partner, ADS Conseil: andres-adsconseil@wanadoo.fr

Didier Cahen, Chief Executive, Eurofi: cahen.didier@wanadoo.fr