PEPP: what needs fixing?

Gabriel Bernardino

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The making of the PEPP: delivering on its promise to European citizens

The Regulation of the Pan-European Personal Pension Product (PEPP) is the European Union's answer to two key policy questions:

- Firstly, how to complement sensibly existing pension systems - in particular, in places where the occupational pension sector is underdeveloped - and how to provide a powerful tool for the retirement savings of a modern, mobile European citizen, working in a changing labour market?
- Secondly, how to reinforce the much needed, efficient and sustainable Capital Markets Union?

"To promote safe products also means implementing relevant controls and limits on product design, including through product oversight and governance measures. "

\- GABRIEL BERNARDINO

The need to save – more – privately to ensure an adequate retirement income comes at a time of a challenging economic environment. Persistently low interest rates, slow growth and the aftermath of the last financial crisis put a strain on long-term savings solutions and challenge the build-up of sufficient financial resources for European citizens' future retirement income. Though pension products benefit from a long planning and investment horizon, the effect of the persistent trends in the economic environment can be felt: the shift to Defined Contribution pension promises and the significant trend towards unit-linked products relocate the investment risks from the institutional investor to the individual saver.

The appropriate design of standardised reference points, i.e. 'quality features,' of the PEPP and initiatives to enhance the understanding of risks and rewards that are intrinsically linked and are necessary to make saving 'worthwhile', help individuals to

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>>> manage their financial planning in this changing – and challenging – economic environment. However, how much more challenging is it for an individual to understand the effects of inflation and the risk of outliving one's savings – the 'longevity' risk-, which are the two main exposures a pension solution has to tackle?

To overcome consumer's behavioural tendencies, such as procrastination, loss aversion or simplistic 'rules of thumb', the PEPP offers a simple approach: transparent, standardised, enforceable, default, quality features that enable comparability, set an appropriate benchmark – and most importantly – consumer trust. In addition to that, such default, standardised features bring economies of scale and efficiency gains to the PEPP providers, expected to result in cost-efficient products and sustainable investments over a considerably long-time horizon.

With the ambition to build a strong, default personal pension product comes the obligation to deliver on the inherent promise to consumers. The regulation of PEPP's high-quality features, such as standardised, relevant pre-contractual and regular information documents, the cost cap and the mandatory use of risk-mitigation techniques, requires smart and innovative approaches, to promote superior pension outcomes and to empower consumers taking good decisions. This challenging endeavour has to be undertaken with the consumers' needs in focus and the practicability for the provider to be always kept in mind.

Private pensions are often regarded as an inefficient market, where consumers' demand is not matched by adequate supply of suitable solutions. Regulation has to address agency conflicts and information asymmetry as shortcomings of an inefficient market. Conflicts of interests need to be acknowledged and the right incentives need to be put in place to facilitate optimised results for consumers. The main tools for enforcing these considerations are a robust regulatory framework, including authorisation regimes, governance, distribution rules and corresponding supervisory powers. To promote safe products also means implementing relevant controls and limits on product design, including through product oversight and governance measures.

Finding innovative solutions for the PEPP, based on the learnings from the current, challenging economic environment, changing demographics and the modern forms of labour, and embracing the opportunities of digitalisation, will make this personal pension product future-proof for the benefits of the European citizens. ●

Frederic Janbon

**Chief Executive Officer,
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PEPP - solving the pension crisis and financing Europe's future

Demographic change poses a clear and present danger to Europe's public pension system. As our populations age there will soon be too few workers putting money into the system to support the benefits already promised to those in retirement. Member states have tried to meet that challenge by gradually phasing in reforms that reduce the generosity of the schemes for future generations. The workers of today will therefore have to increasingly rely on voluntary personal pension plans.

The asset management industry must play a leading role in enabling this shift towards personal pensions by providing long-term investment solutions. In the process, >>>

>>> asset managers will deliver long-term returns for retirees and play their part in financing the transition to a more sustainable and prosperous future for Europe.

We will need to educate savers about the opportunities and the risks that are potentially open to them as long term investors. In theory, illiquid instruments are a good fit for private pension plans, particularly in a world where long-term government bond yields are stuck in negative territory. Illiquid products can offer a much-needed additional return to investors with long investment horizons. But in practice, this will require changes in the regulatory framework to unlock the distribution of the next generation of long-term investment vehicles. Multi-strategy funds diversified over different asset classes, with controlled volatility, could fit the bill.

Pan-European Personal Pension Product (PEPP) has the potential to create a single market for personal pensions and is therefore an important pillar of the wider Capital Markets Union initiative. Asset managers, such as BNPP AM, that are active in many European countries will be well placed to develop a Pan-European offering. With the harmonisation of the rules on providing advice and assessing suitability and the ability to sell online, there is the potential to seamlessly sell one product across national boundaries. The flexibility of investment options and out-payment types of the PEPP will help producers innovate to provide products best suited to investors' needs.

"Industry will deliver long-term returns for retirees and play its part in financing the transition."

\- FREDERIC JANBON

There are teething problems that will need to be addressed if PEPP is to be a success, including the limitation of fees, the cost of capital protection, the disparity of national tax incentives and the need for national authorisations.

The Basic PEPP, the mandatory default investment option, will have costs and fees capped at 1% of the accumulated capital per annum. Capping the cost sounds attractive from the perspective of the customer, but it is important to be clear about the consequences. As with any transaction, capping the cost could constrain the quality of the service that the provider can afford to offer. After all, providing good investment advice costs money. Moreover, fee structures tend to vary across countries (part of the investment management fees often includes distribution costs) so the fee cap could have a material impact in certain jurisdictions.

The capital protection, included in the basic PEPP, is attractive for risk adverse investors but could significantly erode the performance and does not seem economically optimal considering the long investment horizon. Therefore, the possibility given by the PEPP to offer clients lifecycle investment strategies is very important.

Last, but not least, the process of harmonisation is not yet complete. The decision to provide the all-important incentives to participate in the PEPP via the tax code still rests with the Member States. Likewise, PEPP providers will be supervised by their national competent authorities, albeit with EIOPA in the background encouraging the process of convergence.

The moral here is don't let the best be the enemy of the good. PEPP is a welcome step in the right direction towards meeting the pensions challenge and financing investment in Europe's future. The asset management industry should embrace it. However, defining a coherent fee cap and life-cycling and risk mitigation techniques as well as tax incentives will be crucial to make PEPP a success. European Member states will also have an important role to make sure national funds and distribution rules are compatible with a pan European product. ●

Xavier Larnaudie-Eiffel

Deputy General Manager, CNP Assurances

PEPP regulation adopted, but still a long way to go

In June, the EU institutions adopted a Regulation introducing a pan-European personal pension product (PEPP). The PEPP aims to promote private pension savings and long-term investments. It also seeks to foster a more integrated European market for personal pensions that facilitates the portability of individual pension savings across Europe.

There is a clear and urgent need to boost individuals' savings for retirement. Increased longevity and strains on national pension regimes will translate into a massive ageing crisis if nothing is done now to tackle the pension time bomb.

At the most basic level, the PEPP has the potential to help raise awareness about the need for individuals to take responsibility for their future retirement income. A significant increase in long-term pensions savings can also help fund growth and the change to a sustainable society. Depending on the outcome of discussions on the Level 2 measures, the PEPP could also represent a significant opportunity for eligible providers to design and offer new solutions that help to fulfil the economic and societal aims of tackling the pension savings gap, at least in some markets.

The insurance industry is in a unique position to help meet the ambitious PEPP policy objectives, since it is Europe's largest institutional investor and can build on its longstanding experience as the main provider of personal pensions and guaranteed long-term savings products.

However, it is too early to assess whether the PEPP will contribute to the development of an EU personal pension market and channel savings to long-term investments. Indeed, there is a long list of key issues still to be addressed by EIOPA in implementing regulation, including: the content and presentation of information documents; what is included in the 1% cap on costs applicable to the basic PEPP; and the definition of the risk mitigation techniques, which are the criteria to be met for non-guaranteed investment options. This work will have a crucial impact, as it will determine whether the PEPP offers the safety and features wanted by citizens and whether providers are able and willing to design PEPPs.

The success of the PEPP also depends on ensuring that the regulatory framework applicable to eligible providers enables them to fulfil their role, in particular in an environment of low interest rates. As it stands, Solvency II — the regime applicable to insurers and to guaranteed basic PEPP — does not correctly measure long-term risks and as a result is overly conservative. This unnecessarily and adversely affects the cost, asset mix and availability of long-term products such as pensions, which will ultimately have an impact on the performance and diversity of PEPPs on offer.

"The PEPP has the potential to help raise awareness about the need for individuals to take responsibility for their future retirement income."

\- XAVIER LARNAUDIE-EIFFEL

The insurance industry advocates a proper investigation by the EC and EIOPA — as part of the 2020 Solvency II review and PEPP-related discussions — of the mismatch between the current regulatory approach and how insurers are really exposed to risks relating to long-term products, so that it is feasible for providers to offer such products and meet consumers' long-term needs. Improved Solvency II requirements for long-term liabilities would help insurers to provide safe, long-term savings products, including PEPPs. ●

Guillaume Prache

Managing Director, Better Finance

The EU can still save the PEPP: make it simple and use a relevant risks scale

The pan-European Personal Pension (PEPP) product was designed to create a simple and safe personal pension "by ensuring sufficient consumer protection"[1].

However, the design of the PEPP falls short of its objective: the simple, safe and cost-efficient default investment option ("basic PEPP") is no longer simple, requires advice and embeds a capital guarantee scam. For basic PEPPs that offer a capital guarantee, BETTER FINANCE asked to guarantee pension savers' contributions before deduction of fees and in real terms, or – at the very least – prominently warning pension savers that fees and inflation will severely reduce the value of this "guarantee" over time . The voted Regulation however resulted in a "capital guarantee scam", where the accumulated lifetime savings are protected only after deducting accumulated fees, without taking into account the negative effect of inflation, and without any warning.

EIOPA is to draft the delegated acts on the fee cap for the "Basic PEPP",

on "risk mitigation techniques" and on the PEPP Key Information Document >>>

>>> (KID). Unlike what happened to the level II PRIIPs Regulation, it must keep it simple and intelligible for pension savers: lifetime savings and pension adequacy are at stake here.

"The PEPP regulation is "stillborn" since it conflicts with MiFID II before its entry into force."

\- GUILLAUME PRACHE

The annual fee cap of 1% corresponds to the existing cap for personal pensions in the UK, and to the fee assumption in the study on life cycle pension savings commissioned by the asset management industry. It is higher than the average total expense ratio for life cycle pensions in the US. Likewise, it is meant to include all annual ongoing fees: total management, distribution and those charged for "guaranteeing" or smoothing returns if any. It is the opportunity to standardize the definition and components of the total ongoing charges that shall be mandatorily disclosed in the PEPP KID.

Future rules on "Risk mitigation techniques" bear two risks: to be too complex for pension savers, and to rely on inadequate risk scales. EIOPA could find inspiration in the just enacted risk mitigation rules for French personal pensions, that are not too complex an should allow for direct investments in funds, low cost ETFs and listed equities and bonds (within the risk mitigation limits tightening over time); a vital need for decent long-term returns and for achieving the CMU. And the risk scale should be at last adapted to the long-term horizon of a pension product such as the PEPP by taking into account that - over such a horizon - a diversified portfolio of listed equities is much less risky than money market funds or short-term bonds.

Lastly, the PEPP KID MUST not repeat the huge mistake done with the PRIIPs KID for disclosing performance. However, future performance forecasts seem to be back again. Besides the fact that return projections are wrong, confusing and misleading, the PEPP regulation does not require the prominent warning that "such forecasts are not a reliable indicator of future performance". As such, it seems that the PEPP Regulation is "stillborn" since it already conflicts with MiFID II provisions. Long-term (at least not shorter than for the UCITS KIID) past performance alongside with benchmark must be part of the KID. ●

1. European Commission introduction to the proposal for PEPP (COM (2017) 343 final).

Oliver Gilvarry

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PEPP – focus on the opportunities

Ireland has been a consistent supporter of PEPP from the original proposal from the Commission. We see the development of Europe's capital markets is dependent on the availability of funds to invest. As can be seen in other jurisdictions with significant capital markets, a key foundation stone is the existence of funded pension schemes. PEPP is now introducing a product that will provide more freedom, choice and flexibility to EU citizens saving for their retirement. The ability to move your pension around with you within the Union is of huge benefit to Europe's workers, along with the certainty for workers over the way the product will operate across the Union.

Compare this to the current situation where you need to have multiple pension pots, subject to different operating frameworks, versus one standardised product. By making it easier for people to save for their future retirement, we are also providing a mechanism to further develop Europe's capital markets, by increasing the pools of investable monies.

At the same time, we must not ignore the challenges this new product faces. The key strengths of PEPP is its portability and the ability to switch provider. We will need to see how the Level II measures are developed to ensure that the key strengths of the product are effective. We cannot ignore the complications of having a range of providers for PEPP, subject to differing sectorial regimes across different national systems, which has the risk of making the objective of switching complicated.

It is important that the work in the different European Supervisory Authorities on the Level II measures has the ultimate objective of making PEPP easy and attractive to use by European workers. This is what will make the product successful.

The current low interest environment has been noted as a potential disadvantage to the success of PEPP, but we must remember that this is an issue for all types of long-term saving products and for pension products of all types. A real disadvantage to saving for future retirement relates to the charges and fees that are charged. The OECD last year highlighted that an annual fee of 1.5% of assets, would lead to nearly a 30% reduction in a person's pension pot at retirement compared to no charges. By halving these charges to 0.75%, brings the reduction in the pension pot to 17%.

These numbers can be used to highlight the benefits of PEPP which will enable European workers to reduce the costs they can face currently by having pensions in numerous different schemes and across different Member States. PEPP also provides for a cap of 1% on fees for the basic PEPP, which is another welcome introduction.

These benefits must be focused on in order to help ensure that PEPP can become a success, rather than focusing on the disadvantages arising from low interest rates or differing taxation regimes.

The ability to easily port your pension across the Union or switch provider or the ability to reduce costs are all strengths of PEPP. This is why the development of Level II measures by the ESAs must ensure that the key strengths of PEPP can come to fruition and make the use of the product easy for consumers. The success of which will help Europe build another pool of funds to be invested, which in turn will help grow our own capital markets in the Union. ●

Peter Paluš

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The first step in creating Pan-European Personal Pension products market

Negative demographic developments of us, the Europeans, provide for one of the most fundamental challenges we will soon be facing. Its impact on the pension schemes leads us to the necessity of providing our peoples with sufficient and attractive opportunities to save for their retirement. Single market, as we are building it, creates useful European-wide opportunities to come with such reforms. That is why we are here today, discussing the creation of first pan-European Pension Product (PEPP). The question is, have we so far been able to achieve what we intended?

I look at this topic from two different perspectives.

First, we have the project of creating single market for capital, or Capital markets union. It aims at improving cross-border investments, and indeed, real portability of a pension product could be a game changer, especially in light of increased mobility of our workers. It is true that we already have various instruments at EU level, particularly as regards the 1st and 2nd Pillar, but PEPP is truly a pioneer project in the field of personal pension products market at EU level.

Second, PEPP is supposed to be a simple and cost-effective 3rd pillar retirement framework that will increase competition among providers with possibility to tackle new/local markets.

Having said this, I have some doubts whether it will be the real game-changer for use of personal pension products at EU level. Here, I cannot help the feeling that it looks much better on paper than in envisioned reality.

Where I see the limitations? Most obvious ones are touching upon issues such as consumer protection, taxation, historical context, effective supervision – just to name a few. Combined with a complexity of this product, its use in practice may be impeded. Although some of those obstacles are natural, such as the historical difference between pension systems of the Member States, others can perhaps be eliminated. We need to seriously pay attention to the uptake and then, step-by-step, start with improving the framework to move further.

To be even more concrete, in Slovakia the portability of pension products is already possible (here I am talking about pension products provided by SK IORPs). On the other hand, some of the biggest proponents of the CMU project among member states were during negotiations rather skeptical as regards the possibility to introduce the real portability within the PEPP (such as the possibility to consolidate various compartments). If we are serious about PEPP and about CMU, we need to be honest, as it is crucial to support the demand and uptake of PEPP.

Same goes then for the area of supervision, but I do not want to go too much into the whole ESAs discussions.

However, I saw similar developments when banking union was negotiated – on one hand, we had countries with big financial markets demanding single jurisdiction with the banking union, but on the other side, the same countries are ring-fencing investments in the pension sector. Solving PEPP may be a good stimulus to move also the banking union project bit further.

To end on a positive note, I believe in Europe and I believe that pragmatic approach is needed here. Partnerships may be one of the answers, because after all, we are all partners and allies in our Union. ●