PEPP: WHAT NEEDS FIXING?

1. Introduction

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 challenged 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 have relocated investment risks from the institutional investor to the individual saver.

A regulator introduced the key topics for discussion which focused on the opportunities and remaining challenges in the implementation of the Pan-European Personal Pension Product (PEPP). The aim of the PEPP is to create simpler, more transparent and more cost effective personal pensions in Europe, which will contribute to pension sustainability and long term investment in Europe, and better returns for citizens.

2. The key expected benefits of the PEPP

2.1. The PEPP will give more freedom, choice and flexibility fir EU citizens saving for their retirement

An official described how a large number of multinational organisations are based in Ireland, which means a large number of EU citizens will work in Ireland for two or three years before leaving. Ireland sees the PEPP positively, because it allows the mobility of different workforces across the Union by providing choice. It is important to have consistency across EU member states in order to avoid people having multiple pension pots. The PEPP is important, but it will not solve everything immediately. The PEPP also links into Europe's pension shortfall. One aim of the Capital Markets Union (CMU) project is to build Europe's capital markets, but Europe has a yearly pension shortfall of around € 2 trillion. The PEPP has a secondary effect of boosting Europe's capital markets by increasing the pool of investable money. The use of digitalisation in the provision of information to users of PEPPs may also have positive effects for savers on the take up of the product. The PEPP can give savers greater clarity and understanding. Ultimately, the PEPP project is about trying to overcome the inertia for people regarding their saving for their retirement.

A regulator agreed on the need to discuss pensions and retirement planning. The information aspect is very important. Croatia has a completely different situation for Ireland, however. Croatia's population uses the benefits of higher wages and better working opportunities in other member states by working abroad. A product like the PEPP would be interesting for many Croatians who work abroad. While global asset managers are powerful and marketing is important, there is a strong home bias in the financial industry. Many Croatians who move abroad save in domestic banks. The PEPP is an opportunity for the domestic financial industry to offer such products. Another regulator agreed that the PEPP could be highly relevant for any member state's diaspora.

2.2. The PEPP is an opportunity to educate savers about the opportunities and risks potentially open to them as long term investors and will create a single market for personal pensions

An industry representative stressed that the industry is acutely aware of the real need for workers to save in order to make up for Europe's pension shortfall. Some aspects of the PEPP will fulfil this need. The PEPP is a great opportunity for asset managers of all kinds to propose innovative investment solutions to savers across Europe. The first benefit here is on the marketing level. The existence of a European pension plan, with the same name across Europe, will help a bigger percentage of the population to start saving. The second benefit concerns economy of scale. Whether the providers are insurance companies, asset managers or another type of company, they will be able to provide a single solution, which is scalable across member states. Additionally, the co legislators did not decide, for example whether the benefit would be a lump sum or an annuity. This flexibility helps providers and asset managers develop life cycle investment solutions appropriate for both the accumulation and decumulation phases. Another industry representative agreed, suggesting that the PEPP is a true opportunity. While Europe is assessing its progress on the journey to a financial single market and the CMU, it is important to make progress by raising public awareness, especially amongst young people, of Europe's ability to develop concrete solutions for the pension gap.

2.3. The PEPP could increase the mobility of workers in the EU and be a pioneer project

An official noted that one of the highest priorities of the new Commission is to ensure that Europe has an economy that works for people. At a time when Europe faces a significant challenge from negative demographic developments, the PEPP can provide benefits for individuals and society as a whole. The PEPP also has a very positive externality, because it supports mobility within the EU. Secondly, the PEPP can pioneer. The field of pension products is an aspect of social security and social affairs, which is the domain of member states. From this perspective, the PEPP is a pioneering project. Finally, it is important to consider how the PEPP interacts with the CMU. The PEPP can increase the robustness of the EU financial sector by increasing cross border shareholdings, which is one aim of the CMU.

A regulator agreed, noting the indispensable cross border dimension of the PEPP. This cross border aspect is the only way to achieve economies of scale. It will help reduce the concentration of home bias in investment. One of the main problems with pension mechanisms in some European countries is the concentration of investments in certain asset classes. It will be very important to bring pensions to the European level to create mass and to diversify these holdings.

2.4. The PEPP could also contribute to the ESG agenda

An industry representative stated that the PEPP should be green, noting that the project itself mentions the possibility of an environmental, social and governance (ESG) dimension. Europe could finance the CMU and the growth of European economies while ensuring sustainable growth. The EU can 'kill two birds with one stone' by

taking into account ESG factors and the new EU taxonomy. Providers, asset managers and insurance companies should contribute to these definitions. A regular stated that default, standardised features bring economies of scale and efficiency gains to the PEPP providers, expected to result in cost-efficient products and importantly sustainable investments over a considerably long time horizon. It is possible to use this also as a way to target younger generations, because they are rightly very serious about environmental issues.

3. Key issues still to be addressed for implementing the PEPP

There are teething problems that will need to be addressed if the PEPP is to be a success. Indeed, there is a long list of key issues here, including the simplicity of the basic PEPP, the content and presentation of KIDs, the fee cap, the cost of capital protection, the definition of risk mitigation techniques, portability, disparity on national tax incentives, and the need for national authorisation. The success of the PEPP depends on ensuring there is an appropriate regulatory framework, particularly in an environment of low interest rates

3.1. The PEPP must be simple and transparent

3.1.1. Developing a simple product

An investor representative suggested that the principal benefit of the PEPP is to have a safe, simple and cross border personal pension. However, the regulation of last July is no longer very simple and no longer very safe, especially the default or 'basic PEPP'[1]. With EIOPA's delegated acts, there is still a chance to make the PEPP less complicated and much safer. EIOPA's advice to the Commission initially was to have a default option for the PEPP, which was simple and safe enough to be sold without advice. At present, the PEPP is neither simple enough nor safe enough. The investor representative appealed to member states to play fairly not only on tax but on all the other rules. For example, on 7 August, the French authorities issued their risk mitigation techniques for the basic PEPP, which is not overly complex.

An industry representative stated that the road to hell is paved with good intentions. The Key Information Document (KID) related to Packaged Retail and Insurance-based Investment Products (PRIIPs) was extremely simple, but it was very bad. However, people will only buy these products if they understand them. Major European financial groups will find it easy to offer these products because they already cover the entire Union. It will be more challenging for smaller institutions to offer this product without adding complexity or cost. However, the PEPP is an interesting opportunity to provide products for more European countries. It could foster greater cooperation in the insurance industry, for instance. Ultimately, the PEPP must be simple for people and simple for institutions.

3.1.2. Making the PEPP a mass-market product remains challenging

Noting EIOPA's good work on the PEPP, an industry representative suggested that all regulatory texts are imperfect, but there is added value in the implementation of a regulatory text. Therefore, EIOPA's role will be very important. The PEPP will succeed if it both appeals to young educated Europeans, who currently have no adequate pension solution, and also becomes a mass market product. Otherwise, it will not solve either the pension gap or the need for more savings to finance the European economy.

The industry representative explained how it is increasingly difficult to give clients the three advantages that industry wants to give: guaranteed capital, liquidity and an acceptable return. This issue must be discussed with savers and member states, and all parties must decide what to privilege. While institutions privilege the long term perspective, people will not buy the PEPP if they are not convinced of its benefits. The industry representative is convinced that tax is very important to make PEPP a mass market product. If the industry wants people to buy a new product, people have to be sure of its benefits. One good way to do this is through tax incentives.

3.1.3. Transparency and clarity: the KID must be simple and intelligible for pension savers

An investor representative stressed that Europe should not copy paste the PRIIPs KID. The KID is supposed to be the document that consumers and savers understand. The KID must be intelligible, comparable and not misleading. 'Intelligible' means clear and short. 'Comparable' means that the industry must use actual past performance and cost as a percentage of savings to benchmark fund performance. 'Not misleading' means regaining or acquiring people's trust. There must be transparency on the capital guarantee and prominent warnings about the reliability of forecasts. The investor representative concluded by quoting Stanford Professor of Finance Ezra Solomon, who said, 'The only function of economic forecasting is to make astrology respectable.' If the experts do not agree, consumers should not be held responsible.

A regulator emphasised the importance of transparency between different products. PEPP will not live in its own ecosystem. This is very important for the structure of KIDs. An industry representative stated that the basic PEPP is very important, but the industry must be very clear on liquidity and return. Risk mitigation techniques should be defined extremely clearly and there must be transparency on other options. There is no reason why consumers should not be allowed to make direct investments in certain classes of assets.

3.2. The fee cap in the basic PEPP is appealing, but consumers must understand the consequences

The basic PEPP will have costs and fees capped at 1% of the accumulated capital per annum. This cap is a key feature of the basic PEPP and EIOPA has to develop Regulatory Technical Standards (RTS) to specify the types of fees and costs to be accounted for in that cost cap. Securing long-term stable income and adequate future retirement income is the key objective of PEPP. Therewith, risk-mitigation techniques to be applied in the asset/liability and investment management is an integral part of the PEPP framework. It is important for the PEPP to offer clients life cycle investment strategies.

3.2.1. The PEPP's fee cap should have a standardised definition, including its components

An investor representative stressed that the fee cap is only for the default option. This cap is necessary because of the importance of making the PEPP a success and the present interest rate environment. However, it is worrying that the French authorities should have lifted the 15 year ban on inducements for personal pension products. By itself, this will increase fees by 0.75 1%. With negative interest rates, this is not a solution for consumers. The components of the fee cap should also have standardised definitions. An official agreed that the industry's concerns about cost are valid in a zero interest rate environment. Direct investment in ETFs and other asset classes should be considered, but people must know what they are doing. If the PEPP is successful, there will be an entirely new cohort of customers.

3.2.2. Capping the cost could affect the quality of the service that the provider can afford to offer

An industry representative described how providers have two levers able to deliver sustainable returns in the current economic environment. The first lever is how

the provider defines the guarantee or profiling of the investment. The industry representative's firm is very much in favour of life cycle products: in other words, a diversified multi strategy investment that de risks over time. This is more powerful than a guarantee, which costs 'an absolute fortune' in capital. The second lever is liquidity. The PEPP is a scheme for long term saving. There must be a way for the PEPP to be invested partially in illiquid products, which make higher returns than UCITS or daily liquidity products. Acknowledging the existence of the fee cap, the industry representative considers it important to discuss its composition. For example, advising and distributing should not be part of the fee cap. In the UK, many individual savers do not receive advice because it has become too expensive. It will be silly if the less well off part of the population is prevented from investing in the PEPP because they will not receive proper advice. A regulator agrees that this should be balanced against the standardisation of the product, which could help reduce the fees.

Another industry representative agreed, suggesting that their institution also does not support the fee cap. Their institution would obey the law after informing all parties of the risks. The cap will not be excessively dangerous if there is clarity on its composition. The general range of management costs is around 1%. However, firms will have to disclose what is in these funds. Risk mitigation is not true mitigation; there is no zero risk investment. A guarantee has a huge cost in capital, and firms must be transparent. A regulator stated that the cost of the guarantee needs to be very transparent. The industry representative reiterated the importance of not including the cost of the guarantee in the cap, as this would be unmanageable.

3.3. The definition of risk mitigation techniques will be essential for the success of PEPP

The definition of risk mitigation techniques – i.e. the criteria to be met for non guaranteed investment options – is another issue to be addressed by EIOPA. An investor representative felt that the PEPP is not simple. Complexity has been a significant impediment in personal pension products in the past. Secondly, in relation to adapting the risk scale to the time horizon of the pension product, a diversified portfolio of equity is much less risky over 20 30 years than money market funds or short term bonds. It is also crucial for investors to be able to invest directly in investment funds, low cost ETFs, listed equities and bonds.

3.4. The PEPP must be manageable for providers

An industry representative stressed that the success of the PEPP depends on ensuring that the regulatory framework enables providers to fulfil their role. As it stands, Solvency II does not correctly measure long term risks; as a result, it is overly conservative. The cost of capital under Solvency II and persistently low interest rates mean that the most expeditious way of restoring an institution's solvency rating is to sell equities. This problem will impact the performance and diversity of PEPPs. Improving Solvency II requirements for long term liabilities will help insurers provide long term savings products, including the PEPP.

Noting that the PEPP is interesting because it is completely optional, an audience participant queried whether there could be regulatory spill overs from the PEPP into compulsory regulation in other sectors. An industry representative considered it possible for some spill over on the industry's capacity to invest in certain asset classes, especially in the present economic circumstances. There might need to be a multi sector consensus to adapt the rules if Europe should seek to foster further development of the PEPP. Another industry representative did not foresee any obvious areas for spill over, adding that there is a need to ensure that national competent authorities (NCAs) and regulators should make the PEPP simple for market participants and their clients.

3.5. Appropriately determining the mechanics of portability is a key challenge

An industry representative stated it was essential to determine appropriately the mechanics of portability. If the details are not considered thoroughly, Europe will encounter 'roadblocks or even worse'. An official agreed and described how, in their experience, the biggest proponents of the CMU, the Banking Union and the financial union are the same member states currently challenging ring fencing within the Banking Union. Europe must take a broader packaged approach here. Portability is essential. The PEPP cannot lead to a situation where pensions are concentrated in only some member states.

3.6. Member states should give the PEPP an appropriate tax treatment to ensure its success

The decision to provide incentives to participate in the PEPP via the tax code still rests with member states. An official described how Ireland currently offers preferential tax treatment to pillar 2s and pillar 3s. While a final decision has yet to be made, it would make sense to treat the PEPP in the same way as other pillar 3 products. There has been this focus on tax, but it is important to look across the Union and consider the structures of member states' pillar 1s. A regulator agreed that tax is part of the solution, but it is not the only solution. The official noted that tax is a national issue, which can be problematic. The official considered the real issue to be the fact that discussions about pensions have focused on pillar 1, but pillars 2 and 3 also contribute to the sustainability of public finances. If Europe focuses on pillar 1 and ignores pillars 2 and 3, there will be substantial problems with the system. If there was a generous and affordable pillar 1, there could be different policies for pillars 2 and 3. An official warned that, if pillar 1 was linked to the CMU, there would not be a pool of money to invest.

Another official highlighted the potential reboot of the CMU; taxation treatment could form part of this discussion. If the Commission develops a proposal, member states will discuss it. However, it is essential to have a more packaged approach when discussing financial union. There should be no 'cherry picking' in relation to the different topics. A regulator noted that the Commission has been clear that the minimum acceptable tax treatment would be the treatment already available to other personal pension mechanisms. In respect of taxation, an audience participant wondered why the Commission has not offered to match the benefits given by a country to the second pillar. Even a small sum would provide an incentive for member states to act. A regulator confirmed that this was a good idea.

3.7. More consistent supervision is required in the context of a cross border PEPP

PEPP providers will be supervised by their NCAs, while EIOPA encourages the process of convergence. A regulator highlighted the need to leverage the EU's internal market and make the PEPP cross border. An official expressed his personal view that there is a role for EIOPA in the supervision of the PEPP, but it is essential to take account of the principles of proportionality and subsidiarity. The official praised what has been established in the Banking Union, i.e. a system with the SSM at the centre that fully includes national supervisors in its daily work. Over the long term there could be something like that in this area. Another official emphasised the need for consistency in supervision.

One big issue with the PEPP is that Europe has a huge number of entities operating under different frameworks. The European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and EIOPA will be involved at level two, so it is important to secure a consistent approach. The official noted the work done in the recent review process of the European Supervisory Authorities (ESAs). EIOPA and the other ESAs have the tools to establish coordination groups, coordinate collaboration platforms, and a strengthened peer review process that will contribute to achieve the objective of supervisory convergence. Location does not matter to investors. If there is a consistent approach, investors will have confidence in it. The new tools available from the review of the ESAs will be important to achieve this objective.

A regulator considered the European label of the PEPP to be extremely powerful. If something goes wrong in one country, it could destroy the brand of PEPP throughout Europe. Europe must consider the supervision side very closely. An industry representative felt that NCAs must ensure that both product and distribution rules in their countries are compatible with the PEPP product. A regulator suggested that this is the challenge of cross border business. There are multiple approaches to consumer protection throughout Europe, and Europe must simplify this. Another industry representative highlighted the existence of a multi regulatory problem. Different requirements on capital and solvency will create additional complexity. Another regulator opined that Europe is at the beginning of this process. Convergence is important, but Europe must launch the product, see how it functions and then work on the PEPP as it evolves.

4. Conclusion

A regulator felt there could be some effects on other products in terms of transparency and cost effectiveness, if the PEPP is a success and if European consumers trust it. Europe must make the product a success. The regulator noted that EIOPA would return to some of the issues raised in the panel in its forthcoming advice to the Commission. Finally, the regulator stressed that the PEPP is an opportunity for all market participants – consumers, the public sector and the private sector – to deliver something that European citizens will see as acting for them. To put it in the motto of the new Commission, it can be an economy that works for people.

---

[1] For basic PEPPs with a capital guarantee, the speaker's organisation sought to guarantee pension savers' contributions in real terms before the deduction of fees or, at the very least, prominently warn pension savers that fees and inflation will severely reduce the value of this guarantee over time. However, the regulation ultimately resulted in a 'capital guarantee scam', where accumulated lifetime savings are protected only after deducting accumulated fees and ignoring the negative effect of inflation.