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A Pan-European Personal Pension (PEPP)

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This extended brief evaluates key aspects of the forthcoming **Pan European Personal Pension** (PEPP)[1]. The information is obtained publicly and through the author's work in European Union Supervisory Authorities, where additional insight into the PEPP has been gained.

1. Background to the PEPP

The role of personal pensions is to complement state and workplace pensions. They are subscribed to voluntarily and are neither social security-based nor occupational. Within Europe they are thought of as the third pillar of pension saving after social security and workplace provision.

Personal pensions (PP) exist in all 28 EU Member States, but the market has developed unequally, with three countries – Netherlands, Belgium and the UK – representing almost 77% of PP assets under management.[2] The portability and flexibility of pensions across the EU is a very important goal for the European Commission (EC)[3], with 1 in 10 people in work in the EU working either outside of their national Member State or originating from outside the EU.

Out of 250 million European Union (EU) individuals age 25 to 59, 67 million have a PP, but in only 5 Member States do more than 15% of adults have a PP. On average PPs represent 2.3% of household financial assets. The current personal pension sector in the EU has 0.7 trillion Euros of assets. This is expected to grow to 1.4 trillion Euros without the PEPP, and 2.1 trillion Euros with the PEPP, including tax relief.

1 http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52017PC0343

2 EIOPA (European Insurance and Occupational Pensions Authority)(2016), Technical advice on the development of an EU Single Market for personal pension products (PPP), 4 July 2016.

3 http://ec.europa.eu/eurostat/statistics-explained/index.php/Migration_and_migrant_population_statistics#Migrant_population

There remains a question whether the PEPP will penetrate central and eastern EU Member States where it is most needed as a result of more limited state and workplace pension provision. This is discussed further in a later section.

Currently there is no specific EU legal framework on the design, provision and distribution of PPs. PP products are regulated by national legislation with rules that make these products eligible for tax relief typically only in each individual national Member State. As well as national law, PP providers fall under EU sectoral law, for example Solvency II, UCITS Directive, CRD IV, and IORP I and II.

On 4 July 2016, following a public consultation process, the European Insurance and Occupational Pension Authority (EIOPA) published its final advice at the request of the EC on the creation of a single market for PPs.[4] EIOPA suggested that harmonising rules applicable to the different types of providers (eg insurers, asset managers, banks, pension plans) would not be the most efficient tool for reaching the EC's objectives, and that the creation of a Pan-European Personal Pension Product is the appropriate policy to best achieve a Single Market for personal pensions.

On 29 June 2017 the EC launched its legislative PEPP proposal.[5] EIOPA's key advisory group, the Occupational Pension Stakeholder Group (OPSG) was supportive.[6]

Many arguments have been put forward for the PEPP. There is a need to support an ageing of the population and ensure adequate income in retirement. Currently national markets in PPs remain fragmented, and there is limited portability across Member States. Savers are sometimes locked-in to their product, or can only switch or exit at high costs. PP providers are subject to a patchwork of EU and national laws, which leads to a lack of supply side competition. Today there is only one type of PP provider – insurers, and a key aim is to stimulate competition by encouraging IORPS (workplace pension funds) to become PEPP providers. There is also low transparency of product features.

Citizens are rarely able to continue contributing to their PP if they move Member State, so an important goal is portability of the PEPP. Portability would make it easier to work across the EU and save within just one personal pension. Cross-border distribution and hoped for increased efficiency through economies of scale is to be facilitated by granting PEPP providers an EU passport for all 28 Member States.

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[4] EIOPA (European Insurance and Occupational Pensions Authority)(2016), Technical advice on the development of an EU Single Market for personal pension products (PPP), 4 July 2016.

[5] European Commission's Public consultation on a potential EU personal pension framework. Available here: http://ec.europa.eu/finance/consultations/2016/personal-pension-framework/index_en.htm

[6] 6 OPSG Response to the EC Consultation on Personal Pensions (2016). Available here: https://eiopa.europa.eu/Publications/Stakeholder%20Opinions/personal-pension-framework-2016-stakeholders_OPSG.pdf

The PEPP is high priority for the EC, and a flagship project for the ECs Capital Markets Union (CMU) action plan, whose objective is to increase long-term investment in the EU to foster growth and jobs. According to European Central Bank (ECB) data, European households keep around 40% of their financial assets in deposits. Aviva (2016) puts Europe's pension savings gap at around €2 trillion a year for the period 2017 to 2057, equivalent to some 13% of the EU's GDP[7]. The PEPP is a potential means of channelling some of these deposits into a pension product. There is also an expectation that the PEPP will provide a new source of private capital for long-term investment in the EU that will help promote jobs and growth.

In order to concentrate on the PEPP, the Pan-European Occupational Defined Contribution Pension concept has been put on hold indefinitely. All efforts are now on the PEPP. There have so far been three meetings of the European Council Working Party, and rapporteurs (liaison officers) have been appointed. The final goal is to have investments in PEPPs by the end of this Legislature (ie in time for the next European Parliament elections in 2019).

2. General provisions (Articles 1-3 of the ECs PEPP proposal)

The PEPP takes the form of a Regulation. A Regulation is directly applicable in each Member State and does not need to be passed in Parliament as a Directive does. The Regulation is not designed to impact Pillar 1 (State) or Pillar 2 (workplace) pension provision. It does this by being an enabling legislation; meaning that it lies on top of other Directives and does preclude any existing possibilities. To give an example, IORPs such as a defined benefit, defined contribution, or collective risk shared schemes could develop PEPPs without running a conflict between the IORP Directive and PEPP regulation. This is significant because up until now an IORP in one Member State would usually be unable to launch a PP let alone distribute one in another Member State.

The EU considers the Regulation to be 'light touch', with 'just' 70 articles containing mostly guiding rules. The 'light touch' approach is achieved because pension providers are already subject to other financial services regulation. The Regulation recommends that Member States grant the same tax treatment as that of national personal pensions.

The PEPP will harmonise around a set of core standardised features to allow providers to offer the same PEPP across the EU, to pool assets more effectively and to achieve economies of scale. Key harmonised features will cover (1) distribution and information requirements, (2) investment rules, (3) switching of PEPP providers, (4) cross-border portability and provision, and (5) authorization and supervision.

[7] Aviva (2016), Mind the Gap - Quantifying the pension savings gap in Europe. Report available here: https://www.aviva.com/media/thought-leadership/europe-pensions-gap/

The harmonised features will mean the PEPP is able to carry a European label, or badge. Labelling of the PEPP is considered vital to providing EU citizens with the trust and assurance they are thought to need that the product is of high quality.

The PEPP 'label' and public trust in central and eastern Member States
Central and eastern Member States are many in number and the next four candidate accession countries - Albania, Montenegro, Serbia and Turkey - all form part of that region. Birth rates are higher in central and eastern Europe than in Western Europe, and given Brexit the future EU population demographic will shift to eastern Member States. Private pension provision in these Member States is very limited, and the PP market almost non-existent. So it is in these countries that the PEPP stands to make most difference, however incomes are lower and this is unlikely to attract PEPP providers. There is also low public trust, suspicion even, in private pension saving. The European label that the EC is proposing for the PEPP is specifically designed to raise public trust, but will it be enough? Public trust in central and eastern Member States may only lift if Member States have to guarantee that PEPP assets are untouchable by sovereign States. The EC is not proposing this. Without a guarantee many EU citizens are unlikely to find the trust they would need in the system to open PEPP accounts. We have in the past seen governments nationalise private pension assets, claw back tax relief, or seize government bonds already held and replace these with a pay-as-you-go social security promise of equivalent value. Examples of such governments taking over private pension assets are Poland, Hungary, Bulgaria, and Kazakhstan (if this is considered Europe), and examples of governments taking national pension assets are Ireland and France. The lack of Member State guarantee to not touch PEPP assets, or their legal ringfencing, may be an important barrier to take-up of the PEPP.

3. Authorization (Articles 4-10 of the ECs PEPP proposal)
The PEPP Proposal gives EIOPA the authorisation and monitoring power for the PEPP. Since the prudential supervision of PEPP providers will remain with the national competent authorities (NCAs), obtaining EIOPA authorisation will require close cooperation between the two levels of supervision.

The EC hopes that many types of provider will apply for PEPP authorisation - asset managers, insurers, banks, workplace pension funds (IORPs), and other investment firms.

Authorisation and European labelling go hand-in-hand. Authorisation will take EIOPA into new territory, signing-off on quality so that the PEPP provider can use the PEPP label. As an example of complexity here, each PEPP must have a default fund that offers at a minimum a nominal capital guarantee, so the worth and robustness of the guarantee will need to be assessed prior to authorisation, an area that is relatively technical. Once authorised, the PEPP can be distributed throughout the EU. EIOPA will be granted mediation powers for dealing with cross border disagreements. EIOPA is to co-ordinate its work with other European Supervisory Authorities (ESAs) and NCAs.

4. Cross-border provision, tax, and portability of the PEPP (Articles 11-17 of the ECs PEPP proposal)

PEPP savers are to be allowed to continue contributing to the same PEPP when moving to another Member State. For this to happen, providers will need to open 'national compartments' to administer Member State specific tax rules applied to the PEPP. National compartments will allow providers to continue administering the tax obligations related to the assets accumulated by a PEPP saver when residing in one Member State, before moving to another Member State. Opening a new 'national compartment' will allow the saver to contribute and gain tax relief in the new Member state without changing PEPP provider. Having to open a new national compartment is designed to prevent Member States competing on tax relief, although a saver will be able to choose to make an asset transfer from the old national compartment to the new national compartment.

The obligation to create national compartments for each Member State at no extra cost is likely to be a deterrent for some providers to enter the PEPP market, although partnerships and agreements between PEPP providers is not ruled out and this may be a way to control the expense of opening a new compartment each time a saver moves to a Member State where the provider has not before operated. Most providers are likely to be comfortable operating, at least initially, at national level or in a limited number of Member States they are familiar with for various reasons (spoken language, taxation rules, local presence and specific local knowledge, etc), and partnerships may potentially be used beyond this.

Transfers into a PEPP from any national Member State PP is allowed but a transfer from a PEPP to a national Member State PP is not allowed. The aim is to prevent possible tax relief arbitrage where the PEPP tax relief is not as generous as national Member State tax relief.

Member States will have to apply national tax treatment if the PEPP matches all the national criteria for tax relief, and Member States are encouraged to grant tax relief when the PEPP does not match all national criteria for tax relief. The tax treatment of the PEPP by Member States is likely to have a considerable impact on the take-up of the PEPP because savers are sensitive to tax incentives. At present one single tax regime for the PEPP is not envisaged and unlikely to occur, though a small group of wealthier Member States may themselves try to converge towards a common tax regime for the PEPP. Currently the level of tax incentives for PPs take different forms across the EU, as well as where in the process relief is applied, being variously applied to the contributions paid in, investment returns, or when paid out as a retirement income.

5. Distribution and information requirements (Articles 18-32)
The PEPP will be able to be distributed by banks and insurers, insurance agents and brokers, investment firms, fund managers, and IORPs, through a variety of distribution channels. One possible barrier is that the different providers and distributors will continue to fall under different distribution regimes, ie the insurance distributors would fall under the rules set out in the Insurance Distribution Directive (IDD) and the investment firms under the rules set out in MiFID II. Other PEPP providers and distributors would have to comply with all the provisions of the Regulation. The EC is to specify pre-contractual information for the PEPP modelled on the Packaged Retail and Insurance based Investment Products Regulation (PRIIPs).

6. Advice (Articles 25-26)
Each PEPP's default investment option can be sold without advice. The EC expects that many savers will be interested in receiving advice about the PEPP due to the potential consequences on retirement income. Advice will be needed where an investor actively chooses a non-default investment option. A PEPP saver will be able to opt-out of advice.

7. Investment rules and switching (Articles 33-39 and Articles 45-50)
PEPP providers are to invest according to "prudent person" rules. This will provide investment freedom in capital markets and prevent national Member States from imposing their own individual investment rules, which they often currently do under the IORP Directive.

The number of investment options will be limited to five per PEPP. Savers are to be given the possibility of changing investment option once every five years and of switching PEPP provider once every five years. Switching costs are to be capped at 1.5% of assets switched. Savers will be able to change their decumulation option once every five years.

The default investment option must at a minimum to ensure capital protection.

> "*the default investment option shall ensure capital protection for the PEPP saver, on the basis of a risk-mitigation technique that results in a safe investment strategy*", (Article 37.1)
>
> "*capital protection shall allow the PEPP saver to recoup the capital invested".* *(*Article 37.2)

The protection referred to involves nominal capital, which over the long-run inflation and investment returns are expected to significantly exceed.   Nominal capital protection is a minimum, and PEPP providers can go further.

Investment protection is central to the principle of protecting the interests of EU citizens as they move from one Member State to another, but the EC has so far not said anything about the prudential requirements of the guarantee.

The guarantee of nominal capital contributed involves a greater guarantee in a PEPP environment than in a workplace pension environment because in the latter the employer also contributes. With the employer contribution added to the member contribution, plus tax relief, there are very few circumstances in which a workplace pension plan would not return nominal capital contributed by savers. This suggests that in a PEPP environment the guarantee will be more expensive, and cost burden on savers is something the EC wishes to avoid.

As things currently stand the level of protection does not depend on the saver's needs or their national pension systems. The protection is continuous, with the EC not suggesting that protection be linked to member age.

An obligation to provide a financial guarantee might lead to investment in low risk and low returning assets, such as government bonds and money markets, which would go against the CMU's aim of fostering investment in equity and increasing private sector economic growth. A financial guarantee may also create a significant barrier to entry as only some providers would be able to offer such guarantees.   This is going to be interesting territory, but may also be a relatively unique selling point for the PEPP.

8. Other aspects of the accumulation and decumulation phase (Articles 40-44 and Articles 51-52)

In other areas of the PEPP, flexibility is to be preserved so providers can adapt to national laws and criteria for tax relief. For example, there is no harmonisation of the minimum age for taking benefits, minimum duration of contributions by savers, or maximum age to start contributing. Providers will have the choice of proposing different types of decumulation, through annuities, lump sums, regular withdrawals or a combination of options. Providers decide which they will offer, there is no compulsion. Providers will also have flexibility about biometric coverage, ie risks linked to longevity, disability and death.

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