At last, a Pan-European Pension Product!

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Introduction

The most important initiative taken so far within the Capital Markets Union (CMU) is a proposal for a Pan-European Pension Product (PEPP). After adopting two sell-side proposals – one covering securitisation and the other, prospectus rules – called for in the CMU Action Plan, it was time for a major buy-side initiative. The discussions on a pan-European pension product have long been brewing, but the proposal is now firmly on the table.

Modelled on the example of UCITS, PEPPs provides for a pan-European product that would be on offer alongside national pension product regimes. An interesting novelty is that authorisation will be in the hands of the European Insurance and Occupational Pensions Authority (EIOPA), but prudential supervision will reside with the national authorities. The two ‘tricky’ elements for the discussions in the European Parliament and Council will most likely be the capital protection for the default investment option and the non-discriminatory tax treatment in the form of the so-called national compartments.

Unlike the rules governing UCITS, this is the first time the EU has brought out a financial product measure as a regulation. The Commission justifies the proposal on the basis of the high degree of fragmentation in private pension products available (under so-called 3rd pillar schemes) in the member states and insufficient retirement income for many Europeans. According to Aviva (2016), Europe’s pension savings gap is projected at around €2 trillion a year for the period 2017 to 2057, equivalent to some 13% of the EU’s GDP. European households by and large keep their financial assets in deposits, rather than investing them in funds or directly in the capital markets, which is standard practice in the United States. The Commission argues that PEPPs should become a ‘quality label’, like UCITS, and attract these savings into better-performing assets.

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EIOPA authorisation

With authorisation, or its withdrawal, placed in the hands of EIOPA, the Commission has assigned the Authority its first supervisory tasks. EIOPA is responsible for keeping a central register of funds and for monitoring pension products established or distributed in the territory of the EU to verify that they do not use the designation "PEPP" inappropriately. Existing national pension products can also be converted into PEPPs upon agreement by EIOPA. But only duly authorised financial undertakings will be allowed to manufacture and distribute PEPPs. In particular, the initiative is expected to increase competition in a market dominated by insurers (approximately 90% of personal pension assets), thereby creating new opportunities for asset managers, pension funds, banks and investment firms.

Since the prudential supervision of PEPPs will remain with national authorities, obtaining EIOPA authorisation will require close cooperation between the two levels of supervision. It is a welcome move to step up financial integration in a market that is so highly fragmented today. And it could set a good example for UCITS markets, which, despite sporting a European label, are nationally authorised and are also highly fragmented. The challenges for EIOPA and the national authorities will be to manage the huge diversity in the organisation of national pension savings markets, and to be creative in setting up administrative platforms.

The investment rules of PEPPs follow the ‘prudent person’ rule, meaning that the assets should be well diversified (including traditional instruments and their alternatives) in the best long-term interests of PEPP savers, ensuring the quality, liquidity and profitability of the portfolio. For the most part, they should be invested in instruments of regulated markets. But, as stated in Art. 33, 1b of the proposed Regulation (European Commission, 2017a), “investment in derivative instruments shall be possible insofar as such instruments contribute to a reduction in investment risks or facilitate efficient portfolio management”.

The 5-5-5 options

The PEPP saver may choose from up to five investment options, with the default, or standard option, being “capital protection” (Art. 37, risk mitigation techniques to be worked out in a delegated act). Capital protection will allow the PEPP saver to recoup the capital invested. Savers can elect to change their investment option once every five years, free of charge (Art. 36). PEPP savers are also allowed to switch providers, but only once every five years and the cost cannot exceed 1.5% of the balance transferred. As with UCITS, a Key Investor Document (KID) will apply on information disclosure. PEPPs can be sold with or without investment advice. The distribution rules consist of the existing sectoral rules, contained in MiFID II and IDD (Insurance Distribution Directive), combined with PEPP-specific add-on provisions.

PEPPs are composed of an accumulation phase and a decumulation phase, when the benefits will be paid out. The functioning of these phases will be detailed on the basis of the legal requirements and conditions set at national level, unless they are specified in the Regulation. Early redemption would be allowed but the saver would incur a financial penalty.
Uptake?

It is difficult at this early stage to gauge the success of this new pension product. The market potential for PEPPs is currently estimated at €700 billion by 2030, under the assumption that the same tax relief exists at the national level for similar products. In its current form, it might only be of interest to mobile EU citizens, as there may be limited reasons for others to take it up, although this segment is growing. The branding by EIOPA, in cooperation with the financial services providers and industry, and the focus on long-term returns may prove to be an important draw. Finance firms should aim to achieve a market-efficient size for PEPPs, unlike UCITS, and be able to deliver interesting returns, although the providers may be reluctant because of the capital protection of the default option. So far most national personal pension products have reported a net return just above the inflation rate or even negative net returns. For industry, PEPPs could be an opportunity to develop a pension plan for the millions of SME employees across Europe who have no organised pension savings today.

As discussions are now starting in earnest in the Council and Parliament, legislators should be aware of the opportunity that PEPPs provide as an EU-wide pension plan and the gap it fills in the EU regulatory maze. It also responds to the call in the CMU Action Plan for a long-term savings instrument for households. Legislators should ensure that it remains an attractive proposition, which will not be easy because of the huge differences in the national administration of pension savings and the acute sensitivity that exists to any changes in this domain.

References


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