AAE DISCUSSION PAPER

PEPP REGULATION

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actuarial association of europe

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Foreword

This discussion paper considers the proposal for a Pan European Personal Pension product (PEPP) introduced by the European Commission as a draft Regulation published on 29 June 2017.

The AAE supports this initiative which will provide additional opportunities for retirement saving, particularly for consumers in some Member States where existing opportunities are limited. Branding the PEPP as a European pension product regulated at European level may encourage consumers to have greater trust in retirement saving in such markets.

There is a difficult balance to be struck between the objective of a common European framework and the need for some flexibility to provide for national requirements and practices. The AAE considers that in order for the PEPP to be successful, more flexibility should be provided than is set out in the draft Regulation. This paper identifies a number of areas where we consider that the Regulation should set out principles with Member States should being given additional flexibility to determine the detailed requirements in relation to PEPPs distributed in their jurisdiction.

It is proposed that PEPPs may offered by different types of providers. It is important to ensure that consumers are aware that the different types of provider are subject to different regulatory, distribution and information requirements so that they can make an informed choice. In making a choice between different products, consumers will place considerable reliance on the projected benefits at retirement set out in the documents provided to them, and it is essential that these projections are fair, clear and not misleading, as well as consistent between different product types and different Member States.

The AAE wishes to assist the European Commission, the European Parliament, the Council and other stakeholders in developing a framework which will deliver PEPPs which meet consumer needs. In particular, we are well placed to contribute to further work in relation to the specification of risk mitigation techniques as envisaged in the draft Regulation, and in the construction of performance scenarios for the projection of retirement outcomes which are meaningful to the consumer.

Thomas Béhar
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AAE DISCUSSION PAPER ON PEPP REGULATION

The Actuarial Association of Europe (AAE) welcomes the proposal to develop a PEPP as this could provide an option for consumers who wish to make additional savings for retirement, particularly in Member States where the personal pensions market is underdeveloped, or where the first pillar State pension and the second pillar occupational pensions (IORPs) are not expected to provide sufficient income in retirement. It could also facilitate providers who wish to expand into additional markets but are currently hampered by the fragmented nature of pension provision in different Member States.

As the proposal is in the form of a draft Regulation, it will not require transposition into national law. However, there are a number of areas in which flexibility should be provided in order that national requirements and practices can be taken into account, rather than imposing a *"one size fits all"* framework. There are also a number of aspects of the draft Regulation which we believe require careful consideration by Parliament and Council and these are discussed further below.

Providers

The Regulation provides for PEPPs to be sold by a range of financial institutions, including insurance companies, banks, investment funds and IORPs. Whilst this will broaden the number of providers, it must be recognised that the regulatory frameworks for such providers are different e.g. insurance undertakings which come under the Solvency II framework are required to hold regulatory capital to back insurance risks, whereas other providers have no such requirements. This may provide scope for so-called *“arbitrage”* in relation to regulatory framework, as well as in relation to tax treatment and consumer protection requirements. In our view, if the providers have to meet different regulatory requirements, this means that the products offered by each type of provider are intrinsically different given the protection at entity level, and it is important to ensure that consumers are made aware of this in a comprehensible way both at contract inception and when switching provider type.

We note that IORPs have been included in the list of potential providers but the current IORP Directive applies only to second pillar vehicles reflecting an employer/employee relationship, whereas a PEPP is a third pillar *“personal”* pension product. We believe that some IORPs may wish to offer PEPPs to individual savers (i.e. with no requirement in relation to an employment relationship) and we appreciate that those who manage IORPs have knowledge and experience of retirement savings and may therefore be trusted by the consumer to provide a suitable PEPP. This must not lead to potential for detriment to existing members and beneficiaries of the IORP, or to the sponsoring employer(s), or vice-versa. As noted above, it is essential that the consumer is made aware of the differences between the IORP and alternative providers. The different regulations (prudential, distributions, information) have a considerable impact on the risks managed, the costs incurred and the performance of the proposed PEPP products.

It should be recognised that, other than IORPs which fall under Article 15 of the IORP Directive, providers which are not insurance undertakings which come under the Solvency II framework may not offer PEPP products with biometric risk coverage.

Tax treatment

In order for the PEPP to compete successfully with other pension vehicles, it will be necessary for Member States to provide tax incentives to PEPP savers which are no less favourable than for national pension products. We recognise that as tax is a Member State competence, this cannot be mandated by the EU but we support the Commission recommendation that Member States provide the same tax incentives in relation to PEPPs as they do for national pension products. This may create a difficulty in Member States where the most favourable tax treatment is available only in respect of a product which includes certain features which may be inconsistent with the PEPP requirements. It may also lead to a new set of rules in some Member States which will probably increase the complexity of the tax arrangements, not only but especially for occupational pensions.

Portability/national compartments

Given that there are differences between Member States in relation to tax treatment and other issues specified in the Regulation as being Member State competences (decumulation options, retirement age, early retirement options etc.) it makes sense to have a separate national compartment in respect of each Member State in which the PEPP saver has paid contributions.

We note from Article 13(3) that a provider will be required to offer national compartments in all 28 Member States within 3 years of establishment (presumably even if the provider has no PEPP savers in a particular Member State and is not actively marketing the product in that Member State) and Article 14 requires that a new compartment *"could be opened",* while Article 15 requires that this information must be provided within 3 months of a request by an existing PEPP saver who is moving to a different Member State. In such circumstances, it will of course also be necessary to have a national compartment in relation to the Member State in which the saver resided when he/she commenced saving to the PEPP. We recognise that in order to be pan-European, the PEPP must be available to customers in each Member State but this seems onerous and could inhibit some potential PEPP providers from entering the market.

We suggest that this might be facilitated either by (a) permitting the requirement to be met if the PEPP provider undertakes to facilitate transfer to another similar PEPP provider without charge (i.e. a *"partnering"* arrangement) or (b) if standard documents were prepared by EIOPA, with input from Member State competent authorities, setting out the specific requirements in each Member State (in the national language(s)) thereby reducing the cost to the providers of making PEPPs available in that market. However, even with these measures there would be a high degree of complexity with regard to approval requirements for EIOPA, administrative demands as well as information requirements for providers and comprehensibility for consumers.

Article 16 requires that a PEPP saver who moves from Member State A to Member State B must be given the option to transfer (without cost) his/her accumulated funds from national compartment A to national compartment B. This has the potential to facilitate tax arbitrage i.e. a saver might move his/her funds before or at retirement to the national compartment relating to a Member State which applies a more favourable tax regime.

Accumulation Phase - Investment options

We agree that the *"prudent person"* rule should apply but we acknowledge that further consideration be given to the provisions in relation to investment options:

(a) Number of options

Article 34(1) states that *"PEPP providers shall offer up to five investment options to PEPP savers".* We agree that the number of investment options available to each PEPP saver should be limited as providing too much choice discourages saving[1]. We do not think that it is necessary to specify a maximum number in the Regulation as in some markets a maximum of 5 (of which one must be the default) may be considered too low to provide a reasonable spread. It is not clear from the text quoted above whether the **PEPP product** can only have 5 approved options, or whether each **PEPP saver** can only be offered 5 options (i.e. segmenting the potential market).

(b) Default option

We agree that each PEPP product should have a default investment option for PEPP savers who are unable or unwilling to make a decision about how their savings should be invested, and experience shows that the majority of savers do invest in the default strategy. In addition, where a customer waives the right to take advice, it seems appropriate to require that the default option is adopted in such cases, as provided in Article 26(1).

Article 37 states that *"the default option shall ensure capital protection".* We do not think that it is necessary or desirable that the default option be specified in the Regulation; we recommend that the Regulation should set out high-level principles regarding the selection of the default option, such as a requirement that it does not require future active decision making by the saver, with the selection of the actual default option left to the provider, subject to approval of the national supervisor. This would ensure that the PEPP product is aligned with national practices and consumer preferences while respecting the main objectives of the EU.

Products with capital guarantees might be offered as an option, but not as the default: these may be appropriate for savers who are very risk averse or who have a short period to retirement where the guarantee would have greater value. However, protection of capital does not provide any protection against inflation, which is another risk to savers. It should also be recognised that it is important to define the risks to which the saver is exposed i.e. if he/she intends or is required to purchase an annuity at retirement, capital protection before retirement will not guarantee the level of annuity which can be purchased at retirement, as annuity prices will rise if interest rates fall before retirement.

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[1] Thaler, R. H., & Sunstein, C. R. (2008). *Nudge*. London, United Kingdom: Penguin Books.
Thaler, R.H. (8 December 2017). *Nobel Prize Lecture*. Stockholm: https://youtu.be/ej6cygeB2X0?t=2140

Capital protection in the early years of a policy could also be important for savers for whom negative returns after commencement could lead to a loss of trust in retirement savings e.g. as in the Foundation phase in the NEST default structure in the UK. The concept of capital protection is intrinsically linked to the saver's investment horizon.

If the PEPP offers capital protection, we recommend that this guarantee applies **only at the point of decumulation**. If the guarantee were to apply at all times during the accumulation period, savers may be expected to switch providers if the market value of their investments were below the minimum guarantee, which would require the provider to hold additional capital, thereby increasing the cost of the product for the consumer.

However, we do not think that requiring the default option to ensure capital protection is necessarily in the best interests of the consumer, because the value of such a guarantee is very small for a PEPP saver saving over a period of 30 to 40 years due to inflation. In addition, this requirement may reduce the number of institutions who wish to become PEPP providers.

The AAE considers that long term savers should normally invest primarily in real assets such as equities which are expected to provide long term growth, with a transition to assets which match the individual's chosen decumulation option as he/she approaches retirement age, using a life cycling approach e.g. if the retirement proceeds are to be taken as a cash sum, it may be appropriate to transition to cash, but the best matching assets for an individual intending to purchase an annuity are high grade fixed income assets of a duration which matches the individual's post-retirement life expectancy. Ideally, the life cycle strategy would be personalised to the requirements of the individual saver, but we do not think that it is appropriate or practical to include such a requirement in the Regulation.

(c) Alternative investment options

Article 38(1) requires that at least one of the alternative investment options must be *"cost-effective"*. It is not clear what is meant by this term, but we would expect all options (including the default) to provide *"value for money"*.

(d) Risk mitigation techniques

Article 39 provides that the Commission will adopt a Delegated Act, specifying the risk mitigation techniques to be incorporated in the investment options, so it is not clear at this stage what investment strategies will come under this heading. However, the requirement that all options must include some risk mitigation techniques would appear to rule out offering a simple active equity or property fund, which might be suitable options for a long-term investor. The AAE would be happy to provide input to the Commission in relation to the specification of the risk mitigation techniques.

Change in investment strategy and switching of PEPP Providers

A PEPP saver may change his/her investment option (without changing PEPP provider) *"once every five years"* and this must *"be free of charge to the PEPP saver"* [Article 36]. The provisions for effecting a switch of PEPP provider are set out in Chapter VII; Article 45 (3) provides that this may be done *"no more frequently than once every five years"* with fees and charges as set out in Article 48. We interpret these provisions as prohibiting PEPP providers from permitting changes of investment strategy or switching of providers more frequently than once every five years, even if the providers are willing to provide this service.

In an ideal world, a saver would decide at outset what long term investment strategy is best suited to him/her and which provider offers the best product which incorporates this strategy, and he/she would remain invested in line with the selected strategy and provider until retirement. This would enable the saver to invest in long term, possibly illiquid assets, which may be expected to give the best long-term results and support the CMU objective of funding the EU economy in the long-term.

However, in practice, there will be many instances where the PEPP saver wishes to change investment strategy, perhaps because of his/her personal circumstances, or becomes dissatisfied with the selected provider, and wishes to switch to an alternative strategy or different provider. It is important that the PEPP saver is treated fairly in such circumstances, but also that the provider(s) are able to recover their reasonable costs arising from the PEPP saver's decision to make a change. If these conditions apply, there is no necessity for a limit on the frequency or penalty of such changes, although frequent switching should not be encouraged, as it is unlikely to be in the best long-term interests of the PEPP saver. In this connection, we would highlight the importance of ensuring that the relevant market conduct rules are followed by market participants (intermediaries, providers, advisers) in situations where a PEPP saver is considering switching product and/or provider so that the best long-term interests of the consumer are respected.

The Regulation permits switching once in every 5 years which we consider strikes a reasonable balance between the need to give some flexibility to the PEPP saver and the desire to encourage investment in longer term assets.

In the case of switching between providers a cap of 1.5% of the amount transferred is imposed. This fixed amount does not capture any reinvestment risk for the provider and might result in systemic risk (e.g. massive dynamic lapses when interest rates rise forcing financial institutions to realise losses on fixed-income assets). We do not think that it is desirable to have a specific cap as this may lead to all providers charging this amount even where a lower amount would be more appropriate. Instead, we recommend that the transfer terms are made clear to the PEPP saver before he/she enters into the contract.

If the PEPP saver wishes to switch to a new provider during the term of the contract, he/she should be provided with a fair transfer value reflecting market conditions at the time, but if the PEPP provides capital protection, this must not apply on switching. Even if the default investment option includes a guarantee of the contributions on an appropriate level at maturity date, it is not practical to provide a similar guarantee on switching before maturity. This may be the intention of the text in Article 49(5) *"The PEPP saver shall bear the costs and any risk of financial loss connected with the capital protection provided by the transferring PEPP provider. This capital protection, allowing the PEPP saver to recoup the capital invested and providing an inflation indexation mechanism, shall be consumed at the moment of switching providers"* but it is not clear.

To illustrate this, consider a saver who invests €1,000 per year in a PEPP which provides a capital guarantee at retirement. After 5 years, the market value of the invested funds (net of expenses) is €4,000 and he/she decides to switch to a new provider. The amount available for transfer should be €4,000, and not €5,000 which is the contributions paid. If this amount is switched to a PEPP offered by another provider which provides capital protection, this provider will guarantee a minimum amount of €4,000 at retirement i.e. the amount transferred to the second provider rather than the amount of contributions paid to the first provider.

Decumulation

The Regulation provides that conditions relating to decumulation, including retirement age, are determined by Member States unless they are specified in the Regulation. Article 52 permits decumulation in the form of annuities, drawdown, lump sums or a combination of these. At present, the options available in each Member State depend on national rules, tax treatment etc. and it is likely that Member States will require that the options available under the PEPP are aligned with those under existing pension products. We recognise that the objective of pensions saving, whether through a PEPP or another vehicle, is to provide income in retirement but we do not think that it would be appropriate to force all PEPP savers to apply their accumulated fund at retirement to purchase a lifetime annuity. Whilst a lifetime annuity provides a guarantee for the consumer, and perhaps his/her dependants, whether it is the most appropriate decumulation approach for an individual consumer will depend on factors such as other sources of income, including Pillar 1 pension, assets, number of dependants etc and we therefore consider it reasonable that consumers should have a choice. It should be noted that if annuity purchase is optional, insurers will price annuities on the assumption that those opting for them are the healthier lives i.e. annuities will be more expensive than if they annuity purchase is compulsory.

We accept the view that if a PEPP saver is permitted to take most or all of his/her accumulated savings at retirement as a cash lump sum, the objective of providing retirement income may not be achieved. We would therefore support a requirement that a significant proportion of the fund (25% to 50%) must be taken as regular income, either

by purchase of an immediate annuity, or by establishing an income drawdown programme, perhaps in conjunction with a deferred annuity commencing at age 80 or 85. This is however inconsistent with the existing requirements in certain Member States e.g. Belgium, United Kingdom, Ireland.

It will probably be necessary to take financial advice before retirement (ideally in time to review the investment strategy being followed in the accumulation phase, to ensure that this is aligned with the chosen decumulation option) to consider the options available; we do not think it would be appropriate to have a default option in the event of an individual not wishing to make a choice. We think that it would not be appropriate to require an individual with a small accumulated *"pot"* at retirement to purchase an annuity which would provide very small monthly out-payments relative to the costs involved so there should be some level below which the fund could be taken as a lump sum.

It is essential that the decumulation phase and the accumulation phase are considered together, and PEPPs should be structured to facilitate a smooth transition from accumulation to decumulation; indeed, the two phases may overlap. This does not prohibit switching provider at the point of decumulation e.g. providing an *"open market annuity option"* to transfer the accumulated funds to an(other) insurance undertaking in order to purchase a lifetime annuity.

The Regulation requires that the PEPP holder decides at the outset of the contract what decumulation approach he/she proposes to adopt at retirement. This introduces a further issue to consider at outset which is unnecessary for those who are many years from retirement. We consider that a decision on how the benefits will be decumulated does not need to be taken until, say, ten to fifteen years before the expected decumulation date. We are aware that there are requirements in national law in some Member States which would make it necessary to specify the decumulation option at outset, but we recommend that any such requirement be a matter for Member States rather than being included in the Regulation.

The Regulation also envisages the possibility of early access to part or all of the accumulation in the case of particular hardship. The conditions relating to, and the tax treatment of, any such early access would be a matter for the Member State, but we support the principle that early access should be allowed on a fair value basis in special, prescribed, circumstances.

Information requirements

Article 23 requires PEPP providers and distributors to issue a pre-contractual key information document (KID) similar to that required under the PRIIPs regime (which does not currently apply to pension products). Article 23(3) sets out some additional information to be provided in relation to the section *"What is this product?"* in Article 8(3)(c) of the PRIIPs KID Regulation [No 1286/2014] and Article 23(6) states that the ESAs will develop implementing technical standards (ITS) in relation to these additional items. It is not clear whether these ITS will also expand on other elements of the PRIIPs KID regulation e.g. the section *"What are the risks and what could I get in return?"* in Article 8(3)(d), which deals with issues such as summary risk indicators, and *"appropriate performance scenarios, and the assumptions made to produce them"*, but we recommend that all relevant aspects in which the PRIIPs KID Regulation needs further amplification for PEPPs be considered **having regard to the long term nature of pension saving**. This is particularly important for the projection at the outset, and during the accumulation phase, of benefits at retirement.

Article 28 sets out the requirements for the PEPP Benefit Statement which includes similar information to the Pensions Benefit Statement required under Article 39 of the IORP II Directive [2016/2341]. Whilst we have some reservations about the requirements of Article 39, we agree that the information provided to IORP members and PEPP savers should be the same as far as possible, along with relevant additional information in relation to the IORP or PEPP provider. In this context, we would again recommend that the pension benefit projections required under Article 39(1)(d) of the IORP II Directive, and referenced in Article 28(1)(a) of the PEPP Regulation, should include a *"favourable scenario"* as well as a *"best estimate scenario*[2] *and an unfavourable scenario"* to give the saver a balanced view of the possible outcomes.

We note that Article 28(2) of the PEPP Regulation states that the Commission will adopt a Delegated Act which will *"set out rules to determine the assumptions on pension benefit projections"* and *that "these Rules shall be applied by PEPP providers to determine, where relevant, the annual rate of nominal investment returns, the annual rate of inflation and the trend of future wages".* This contrasts with the provisions of Article 38(5) of the IORP II Directive which requires Member States to set out these rules.

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[2] We consider that the term *"best estimate"* should not be used in the context of consumer information. *"Best estimate"* means the expected or mean value (probability weighted average over the scenarios) of the future cash-flows. We consider that the information which would be most meaningful to consumers is the *"median"* or 50th percentile i.e. the projected outcome above which lie 50% of the possible outcomes, and below which lie 50% of possible outcomes (based on the assumptions adopted). We believe that consumers may interpret *"best estimate"* as best possible outcome, or alternatively that they may consider that such an outcome is more or less guaranteed.
To avoid confusion, we suggest that the median is shown and described as the *"central projection"* or *"central scenario".*

We strongly recommend that the assumptions adopted for IORPs Pensions Benefit Statement and PEPP Benefit Statements are consistent, although we recognise that inflation and wage increases can vary significantly between Member States. We suggest that the assumptions are set by independent experts, including actuaries, and are kept under review, although it would be inappropriate to change them too frequently.

THE ACTUARIAL ASSOCIATION OF EUROPE

The Actuarial Association of Europe (AAE), founded in 1978 under the name of Groupe Consultatif Actuariel Européen, is the Brussels-based umbrella organisation, which brings together the 36 professional associations of actuaries in 35 countries of the EU, together with the countries of the European Economic Area and Switzerland and some EU candidate countries.

The AAE has established and keeps up-to-date a core syllabus of education requirements, a code of conduct and discipline scheme requirements, for all its full member associations. It is also developing model actuarial standards of practice for its members to use and it oversees a mutual recognition agreement, which facilitates actuaries being able to exercise their profession in any of the countries concerned.

The AAE also serves the public interest by providing advice and opinions, independent of industry interests, to the various institutions of the European Union - the Commission, The Council of Ministers, the European Parliament, ECB, EIOPA and their various committees - on actuarial issues in European legislation and regulation.

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