ACTUARIAL ASSOCIATION OF EUROPE

PEPP Regulation – update on activity

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April 2020

Timeline

- EIOPA has issued two consultations on
  - *technical advice, implementing and regulatory technical standards for the Pan-European Personal Pension Product* (deadline 2nd March 2020)
  - *implementing technical standards for supervisory reporting and cooperation for the Pan-European Personal Pension Product* (deadline 20th May 2020)
- EIOPA has also held a meeting of "academics" [on life-cycling techniques] on 19th February 2020 and a stakeholder consultation on 24th February 2020
- Deadline for EIOPA to develop RTS is 14th August 2020
- Regulation comes into effect on 14th August 2021

AAE Activity

- At July 2019 meeting between AAE and EIOPA, EIOPA invited AAE to submit comments to assist with the development of the RTSs
- Board agreed that we should focus on KIDs, Benefit Statements and Risk Mitigating Techniques
- We established three WGs and held LoopUp meetings to develop positions
- EIOPA issued its first consultation on 29th November 2019, which covered these topics so the three WGs were merged into a single WG to develop a submission
- Falco and I attended the consultation event on 24th February
- Draft response submitted on 2nd March 2020

Consultation document

- Only 60 pages, plus 3 illustrative examples
- Set out in 6 sections

  1. **Introduction**
  2. **Information Documents**
  3. **Supervisory Reporting - Cooperation and regular Exchange of Information between National Competent Authorities and EIOPA**
  4. **Cost Cap for the Basic PEPP**
  5. **Risk-mitigation Techniques**
  6. **EIOPA's Product Intervention Powers**

- Asked 10 questions
  - Open questions
  - Not easy to answer

WG approach

- We agreed to consider 3 of the 6 sections
  - Information documents (KID and BS)
  - Cost cap for the Basic PEPP
  - Risk Mitigation techniques
- We did not directly address the questions but developed our views on the issues raised by the consultation, and other issues which we had already discussed in the separate WGs
- A summary of our submission is being prepared for our website – the full submission will be made public by EIOPA

Key points – Information Documents (1)

- AAE supportive of the provision of “digital-friendly” information, with detailed information in separate webpages i.e. a “layering” approach.
- It should also be possible to access and print all of the information in a single document
- AAE strongly supportive of **consumer testing** and **industry testing** to identify what is “understandable” and “deliverable”; more important than actuarial or technical perfection.
- The presentation of information should recognise that long term investment strategy, outcomes and risks are more important than the short term.
- Consistency between
  - PEPP KID and Benefit Statement (BS)
  - PEPP KID and PRIIPs KID
  - PEPP BS and IORP BS

Key points – Information Documents (2)

- *“the main risk of a pension product is the risk of not reaching the individual’s retirement objective”*
- How to define that objective for an individual saver?
- How to address this in a generic KID?
- EIOPA suggests a number of possible retirement objectives
  - To recoup the capital invested (less costs and charges)
  - To protect against inflation i.e. to recoup the capital invested plus inflationary growth
  - *“to reach a high probability of recouping the inflation-protected capital and to have a good chance to earn additional investment returns and stable future retirement income”*
- We pointed out that to provide an adequate retirement income, it is necessary to pay an appropriate level of contributions; the investment strategy alone cannot deliver this.

Key points – Information Documents (3)

- EIOPA considers the long term risk free rate i.e. the UFR to be an appropriate benchmark for future investment returns – we did not support this as
  - UFR is intended for a different purpose
  - Why should a technical change to UFR impact savers' expected returns?
  - UFR cannot be matched
- AAE supports informing the consumer of the merits (and potential downsides) of investing in real assets
- AAE strongly supports EIOPA's proposal to require that 3 scenarios be shown i.e. including a "favourable" scenario as well as the "best estimate" and "unfavourable" required under the Regulation. We again pointed out that "best estimate" may be a confusing term for consumers.

Key points – Information Documents (4)

- The Regulation requires that past performance figures be shown. We suggest that past performance information should not be provided in the first layer of information.
- The illustration in the KID of past performance for lifecycle products, or those which provide for smoothing, will be particularly challenging.
- EIOPA proposes to compare the past performance figures with the UFR which we do not consider to be appropriate; our preference would be to use a benchmark relevant to the product design e.g. an equity index for a lifecycle product where there is a long term to maturity.
- We would also question the relevance of providing past performance figures for a 1 year and 3 year period for a long-term product; we note that the Regulation refers to "performance of a minimum of 10 years".

Key points – Information Documents (5)

- EIOPA states that "*The summary risk indicator should link the riskiness of the investment option to the relative deviation of the projected pension projection from the best estimate result*".
- AAE commented that combining the investment risk and the shortfall risk into a single indicator is confusing and may not be understood by consumers. We consider that the risk indicator should focus on the long term investment risk, and the illustration of the dispersion of the expected outcomes will illustrate the likelihood of a shortfall relative to the expected/desired retirement income.
- We agree that it is desirable to use a different approach to risk indicators to the numerical scale in the PRIIPs KID in order to make it clear that the risk being measured is different. We have no strong views on how the risk indicator should be presented but would recommend that the various approaches suggested are consumer tested.

Key points – Scenarios

- We support the use of standardised inputs and assumptions based on “risk-free” interest rate plus risk premia based on historic data which would be determined by EIOPA. However, as noted earlier, we do not think that the UFR should be used for this purpose.
- We recognise that inflation is not homogenous across Europe, or even across the Eurozone, but we consider that it would be reasonable to use the same assumption for price inflation for all countries in the same currency e.g. the long-term target of the relevant central bank. It should be made clear that inflation is not a product feature but an external factor.

Key points – Cost cap for Basic PEPP (1)

- AAE is fully supportive of full disclosure of costs of administration, distribution and investment as described in the consultation document.
- AAE also believes that the consumer should be provided with information on any amounts which are applied to provide any guarantee of return of capital, and any biometric risk cover. This may be straightforward to determine in some circumstances, but we recognise that for some insurance products it may not be practical to identify the “cost” of the guarantee and any figures provided might be misleading.
- The most important issue is that all of the costs are reflected in the projection of benefit outcomes (see below). However, the impact of all of these costs, charges and features (whether inside the 1% cap or otherwise) should be captured in the projection of future outcomes in the risk/reward section of the KID.

Key points – Cost cap for Basic PEPP (2)

- The Regulation requires that the KID sets out costs in monetary and percentage terms, broken down between one-off and recurring costs.
- Are the costs shown those in year 1 or an annual average over the lifetime of the product? We consider that the latter would be more appropriate.
- We recommend that various approaches are consumer tested. We suggest that consideration be given to having a brief outline of the charges in layer 1 with more detail in lower layers for those who wish to have it.
- The BS must show the impact of costs on the projected outcome. In our view, the reduction in yield approach is more meaningful than the proposed reduction in wealth approach, which depends, for example on the term of the product.

Key points – Cost cap for Basic PEPP (3)

- We agree with EIOPA's view that the "costs" of any guarantee or biometric risk coverage should not be included in determining the costs for this purpose.
- The amounts attributed to these items must be fully disclosed and transparent and calculated in a consistent manner, so that it is not possible to "hide" other costs under these headings and thereby circumvent the cap.
- The costs of distribution include advice, and it may be challenging to provide the saver "with a personalised recommendation explaining why a particular PEPP including a particular investment option, if applicable, would best meet the PEPP saver's demands and needs".
- Robo-advice which would help to keep costs down, although we would question whether this is sufficiently developed in the market.

Key Points - Risk Mitigation Techniques (1)

- The AAE believe that there are two fundamental principles that the criteria should satisfy
  - Consistent and applicable to all RMTs
  - Able to be communicated appropriately
- The criteria then need to consider:-
  - What risk is being mitigated?
  - How effective is the mitigation?
- The PEPP Regulation gives three examples of RMTs
- *Life-cycling*
- *Establishing reserves which are allocated in a fair and transparent manner to mitigate losses*
- *Guarantees*
- The minimum criteria should be consistent across all types of RMTs.

Key Points - Risk Mitigation Techniques (2)

- A number of stakeholders that will be recipients of the information, e.g. consumers, advisers, regulators. Each might be expected to have different levels of understanding of pensions and financial products and also have different purposes for the information.
- Regulators and advisors may be interested in seeing the detailed methodology and assumptions used to assess the risk and in being provided with some statistical output that measures the risk.
- In contrast it may be more appropriate to provide consumers with a simpler presentation which helps to better understand the risk.
- AAE is supportive to a layering approach being adopted for the communication of RMTs and how they meet the required minimum criteria.

Key Points - Risk Mitigation Techniques (3)

- There are various potential options as to the risk that is to be mitigated, e.g.
  - Return of capital in nominal terms
  - Return of capital in real terms
  - Return to provide a minimal level of income through annuity purchase phased withdrawal
- Article 45 of the Regulation states that "*The Basic PEPP shall … be designed by PEPP providers on the basis of .. a risk-mitigation technique <u>consistent with the objective to allow the PEPP saver to recoup the capital</u>.*"
- Article 46 of the Regulation sets out the objective of risk-mitigation techniques "*to ensure that the investment strategy …is designed <u>in order to build up a stable and adequate individual retirement income</u> …and to ensure a fair treatment of all generations of PEPP savers.*"

Key Points - Risk Mitigation Techniques (4)

- A number of stakeholders that will be recipients of the information, e.g. consumers, advisers, regulators. Each might be expected to have different levels of understanding of pensions and financial products and also have different purposes for the information.
- Regulators and advisors may be interested in seeing the detailed methodology and assumptions used to assess the risk and in being provided with some statistical output that measures the risk.
- In contrast it may be more appropriate to provide consumers with a simpler presentation which helps to better understand the risk.
- AAE is supportive to a layering approach being adopted for the communication of RMTs and how they meet the required minimum criteria.

Key Points - Risk Mitigation Techniques (5)

Risk being mitigated	Pros	Cons
Return of capital in nominal terms	• Easy to understand • Simple to measure • Objective measure • Consistent with article 45's reference to recouping capital	• Does not match consumers exposure to inflation risk • References a lump sum amount rather than article 46's stable income measure
Return of capital in real terms	• Matches better consumers exposure to inflation risk • Consistent with article 45's reference to recouping capital	• More difficult to understand • More difficult to measure • References a lump sum amount rather than article 46's stable income measure • What measure of inflation? • Inflation rate can vary from one EU country to another
Ability to purchase a minimum level of income and/or to drawdown a minimum level of income	• Matches consumers need for retirement income • References article 46's stable income measure	• Conceptually very difficult for consumer to translate an accumulating fund value to a protected level of income • Not consistent with article 45's reference to recouping capital

Key Points - Risk Mitigation Techniques (6)

- **Return of Capital in Nominal terms is likely to be most suited to the basic PEPP**
- How effective is the mitigation? The following elements need to be considered:-
  - The statistical measure used to assess the risk
  - The quantum/level of acceptable risk mitigation
  - How to calculate whether the RMT effectively meets the required level of mitigation
- There are various options as to the risk measure, e.g.
  - Spread of potential returns (e.g. volatility, standard deviation)
  - Percentage of likely scenarios returning less than a certain amount (e.g. VAR)
  - Average value of scenarios returning less than a certain amount (e.g. Tail VaR/Conditional Tail Expectation ('CTE'))
- A regulator should be most interested in the level of return associated with the worst possible outcomes, rather than the standard deviation of returns
- Consumers would also be most interested in level of return associated with the worst possible outcomes.

Key Points - Risk Mitigation Techniques (7)

- This points to either a VaR or CTE measure.
  - The VaR is conceptually easier providing a measure of the probability of a “bad event”.
  - CTE gives a better indication of how bad it is likely to be if the “bad event” happens.
- Recommend consumer testing
- If a VaR measure is adopted, the next step is to consider what minimum quantum should be attached to the VaR measure, e.g. a 95% VaR of loss of nominal capital.
- The acceptable quantum of risk is a public policy issue and the AAE has not offered a view.
- The most natural time horizon is a forward looking measure from “present day” to the expected retirement date.

Key Points - Risk Mitigation Techniques (8)

- There are a number of different approaches that can be used in assessing whether a RMT meets the required minimum risk criteria. E.g.
  - Past performance (over what period?)
  - Monte Carlo simulations
  - Scenario analyses
  - Deterministic approaches based on ‘averages’ for each of the variables
- The AAE believe that the criteria for RMTs should put the consumer at the centre and be described in terms of the impact on the consumer rather than the mechanics of the RMT itself.
- As such the criteria should be <u>output</u> measures rather than <u>input</u> descriptions.

Key Points - Risk Mitigation Techniques (9)

Methodology	Pro	Con
Past Performance	• Easy methodology for market traded product • Easy to understand	• No methodology for with-profit products • Only one scenario. For path-dependent products this can be misleading • Survivorship bias • Does not deliver quantum / threshold? How is a probability of a loss calculated?
Simulations	• Large number of scenarios • Consistent approach across all product types and RMT possible -> comparability	• Need for calibration (and regular updates for calibration) • Who calibrates? • What are the underlying market assumptions (calibration)? • Implementation costs
Scenario analyses	• Relatively easy to implement • Easy to understand	• Who generates scenarios? • What are the underlying market assumptions (calibration)? • What is the right number of scenarios? • Who decides on scenarios? • Does not deliver quantum / threshold? How is a probability of a loss calculated or how many scenarios are needed to give meaningful results?
Deterministic approach	• Easy to implement • Easy to understand	• Who determines the assumed returns? • What are the underlying market assumptions? • Many risk mitigation algorithms (like CPPI) cannot be tested on constant scenarios. • Does not deliver quantum / threshold? How is a probability of a loss calculated?

Conclusion

- AAE has made its submission on the consultation and stands ready to assist
- Consumer testing is ongoing although this may be challenged by the COVID-19 restrictions?
- Other organisations have also made submissions which are in the public domain
  - InsuranceEurope expressed concerns about (ab)using the UFR, disclosure in real terms, and measuring risk by reference to dispersion of returns. Recommends independent expert panel to define standard assumptions for projections. Cost of the guarantee and the cost of advice should be outside the 1% cap. Principles based approach to RMT.
  - EFAMA support transparency of costs, but wants costs of advice and transaction costs outside the cap. RMTs should provide for savers to recoup capital at decumulation with a specified % probability. Don't support use of a benchmark return with past performance
- Will EIOPA be able to deliver on time?

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