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«They say things are happening at the border, but nobody knows which border» (Mark Strand)

Picking up the gauntlet – Europe's answer to the 'pension problem': the PEPP

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Abstract: *Over the recent years, pension policy has become an ever more important topic throughout Europe. This article contains a description on the PEPP and its consumer protection elements, potential uses and its Level 2 measures. The Authors concludes that the PEPP can help break down these barriers as well as contribute to a high level of consumer protection, for example via limiting the costs and providing detailed information requirements.*

Summary: 1. Introduction. – 2. The PEPP. – 3. The Pan-European Pension Product: consumer protection. – 3.1 Sub accounts. – 3.2 The Basic PEPP. – 3.3 The right to information. – 3.4 The occupational PEPP: friend or foe. – 4. Conclusion

1. Over the recent years, pension policy has become an ever more important topic throughout Europe.[1] In several countries, the prevalence and need to reform the pension systems have become the spearhead of political agendas.[2] These reforms are caused, inter alia, by demographic and economic changes.[3] For example, in 2018, 19% of the European population belonged to the 65+ demographic, which is predicted to increase drastically resulting in an old age dependency ratio of 50% in 2050.[4] Of course, this puts severe pressure on national budgets.

Another problem facing the EU regarding pension schemes is the lack of the so-called 'portability' of pension schemes and pension capital.

Portability, meaning roughly speaking the collective or individual transferability of pension rights to another provider (be it in another Member State) [5] has been an issue for several years[6]. The EU legislator tried since the last century to enhance portability for providers and consumers.[7]

Furthermore, there is a growing need of transparency and consumer protection vis-à-vis pension schemes.[8]

An important way to deal with the above-mentioned problems in the EU, is the so-called 'Pan European Pension Product', the PEPP.[9] The Level 1 Regulation was adopted in 2019, the Level 2 measures will be finished by the end of 2020.

The object of PEPP is to lay down uniform rules on the registration, manufacturing, distribution and supervision of personal pension products that are distributed in the European Union under the header of PEPP. PEPP intends to establish a separate regulatory framework for personal pension products on an EU level. According to the European Commission (EC), this will benefit consumers as the proposal envisages more choice for savers, greater market competition, consumer protection via stringent information requirements, distribution rules and a simple default investment option. PEPP savers will be able to switch providers and continue contributing to their PEPP when moving to another Member State.[10] Moreover, the PEPP will be contributing to the development of a Capital Markets Union (CMU). A more developed market for personal pensions in the EU will channel in fact more savings into long-term investments and increase the depth, liquidity and efficiency of capital markets. This will ultimately promote growth and the creation of new jobs in the EU and contribute significantly to achieve a single market for capital in Europe[11].

The tiered law-making process that characterizes financial markets have quite some advantages on stemming from the interplay between levels[12] At level 1, the Council of Ministers (comprising the national ministers) formulate the principles or frameworks. At level 2, EU agencies[13] , make the draft legislation, after which the Commission further elaborates these principles , with the assistance of the second level committees (made up of representatives of the Member States' sector-specific ministries, also referred to as 'comitology'). At level 3, the national supervisory authorities collaborate in advising on the regulation and implementing the supervision. At level 4, the European legislation is implemented by the Member States and the European Commission ensures that this is done correctly, if necessary by commencing an infringement procedure pursuant to Article 258 TFEU.

2. The need for a PEPP has been set out in previous contributions.[14] As said, the EU market for pensions is severely underdeveloped and the IORP I[15] and IORP II[16] Directives where and are far from perfect. Even though the introduction of cross-border possibilities for IORPs, this market remains very small.[17]

Whereas the European Union has made its mark on the legal landscape concerning financial institutions in light of developing and regulating the internal market and addressing risks connected with financial crises, (personal) 'pension' still is left unregulated to a great extent.[18]

Where many legislative financial initiatives mainly focus on prudential requirements and informational provisions, putting in place a legal framework for the providers of financial services,[19] the PEPP takes a different approach.

On the 29th of June 2017, the European Commission launched the proposal for the PEPP, which was completed in the summer of 2019.[20] On the 14th of August 2020, EIOPA finished drafted the Level 2 legislation.

The PEPP is based on the so-called 2nd regime: a new regime alongside the 27 existing regimes of the EU Member States. The 'bonus' of the PEPP lies in the additional character: Member States can maintain their current ways of operating pension schemes, but in addition there is this extra, voluntary[21] framework for pension savings.[22]

This also means – amongst others – that providers of the PEPP are able to opt-in to the Regulation, after which their pension product may be labeled a PEPP but at the same time need to comply with the Regulation. In short: the EU created in theory a 'safeguard' label for a pension product with the (potentially greatly) beneficial European passport which enables the PEPP consumer to move to another Member State while keeping the same pension product. This PEPP-passport might offer the (i) the cross-border worker or for example the digital nomad an easy way to accrue an income for retirement in a single 'pension pot' as well as (ii) pension providers to enter the European internal pension market.

In the next paragraph, we will discuss some of the features of the PEPP and its possibilities and limitations.

3. As stated before, the PEPP is in essence a quality label for personal pension products.[23] As soon as it fulfills the criteria as set out in the Regulation a provider may make an application for a license with its own national competent authority.[24] The regulator will assess if the product complies with the consumer protection elements and social, labor and tax laws of the sub-accounts.

3.1. To understand how the PEPP works, it is important to give an overview of the compartmental approach of the PEPP, called sub-accounts. The Regulation defines a sub-account as follows:

"Sub-account means a national section which is opened within each PEPP account and which corresponds to the legal requirements and conditions for using possible incentives fixed at national level for investing in a PEPP by the Member State of the PEPP saver's residence; accordingly, an individual may be a PEPP saver or a PEPP beneficiary in each sub-account, depending on the respective legal requirements for the accumulation phase and decumulation phase;"[25]

The main idea behind the sub-account is that it complies with the national legislation of the home Member State of the PEPP consumer. Via this approach, a major issue is tackled: the tax hurdle.[26] According to a report of Ernst & Young, the European Union (including the UK) has in place 48 different systems of taxation for personal pension products. As taxation is the competence of the Member States and can only be regulated via unanimity, the PEPP does not contain any rules that interfere with this competence. Rather, the sub-account corresponds to each system of taxation,

bypassing the problem by not addressing it. However, in light of consumer protection and consumer choice, the latter of which is highly influenced by preferential fiscal treatment, it is a shame that the recommendation by the Commission to grant PEPP pension products equal treatment as national products was rejected. In light of consumer protection, this might've been a good step forward.

3.2. There's been a lot of debate concerning the default option of the PEPP. Ranging from having just one option to multiple defaults (sic), the discussion resulted in the adoption of a Basic PEPP, designed to be simple, safe and value for money.[27] As the default option was most likely to be chosen by the PEPP saver and carried a European label of quality, it became an important part of the political discussion revolving around two main questions: what investment techniques are allowed and how should the costs and fees be kept to a reasonable level. The first question comes down to the debate that has been going on for quite some time now around the use of Defined Benefit (DB) and Defined Contribution (DC) schemes. In short; the insurance industry highlighted the fact that the capital accrued by the saver needs to be protected against loss, which could be done by providing a guarantee. However, asset managers (and consumer organizations) pointed towards the high costs of such guarantees and the impact on the returns, stating that a life-cycle investment option was the better choice.[28] In the end and in a political compromise, both options were allowed under the Basic PEPP – with additional requirements elaborated upon by the European Commission.[29]

However, the introduction of life-cycling as a 'pension' product raised concern, especially with politicians from countries that are culturally used to defined benefit schemes, so further compromise was needed. This led to the introduction of the fee-cap of 1%. Although not set in stone and subject to review by the Commission every two years, the fee-cap does put in place a barrier for market entry as the launch of a cross-border product is often expensive. As the schism between DB and DC is still very real, when developing the technical standards on defining what costs fall under the 1% EIOPA had to exclude the costs of providing guarantees from the otherwise all-inclusive fee-cap.[30] Furthermore, the level 2 measures drafted by EIOPA do not contain a definition of a guarantee which means that it remains largely unclear what costs are in and excluded when offering a product on the basis of a capital guarantee: does this refer to a nominal guarantee, net from accumulated fees at maturity? Has the guarantee be calculated on via the methodology of Solvency II?[31]

Ironically, this has led to the situation that the Basic PEPP might not always be the most fitting choice for a consumer, simply due to the fact that alternative PEPPs might offer better products that are even more value for money. This split between consumer and provider interests is one of the reasons the PEPP, for some, did not live up to its potential.

3.3. The right to be informed is a core concept of consumer protection law[32], and plays a major part within the PEPP Regulation as well. Based on the PRIIP and IORP- II Directive, it requires PEPP providers to supply the consumer information before signing the contract, upon signing and send updates every year, including additional advice pre-retirement (a 'wake-up call'). This is done via a PEPP Key Information Document and the PEPP Benefit Statement. The contents of these documents

are quite detailed, but the EU legislator introduced the possibility of 'layering' which could greatly enhance consumer friendliness when purchasing a PEPP online.

Besides information documents, the PEPP consumer needs to receive advice upon selecting his or her investment choice as well.[33] The advice needs to be highly personalized, making the provision of advice a complex matter and a costly endeavor.[34] Since advice is mandatory for all PEPPs, it's noteworthy that the specific fee-cap for the Basic PEPP is applicable in relation to the necessary advice, but not for the alternative PEPPs. However, this may lead to the situation that advising for a Basic PEPP isn't as commercially attractive as the costs of advice are not bound by any cap for alternative PEPPs. Article 12 specifically states that "the costs and fees referred to in article 45 (2) which are the reference to the Basic PEPP saver's accumulated capital at the end of the respective year". As there is no accumulated capital in a Basic PEPP upon conclusion of an alternative one, it seems the costs of advice therefore may be charged to the consumer provided that the costs are adequately disclosed.[35]

However, in light of cost-effectiveness and FinTech solutions, the PEPP Regulation enables PEPP providers to offer robo-advice, as long as it provides the same safeguards as face-to-face advice. This possibility might enable and encourage new parties to get a foothold in traditional realm of pensions as well, which the authors consider to be a welcome innovation. After all, if providers are able to safeguard the consumer interests as stipulated in the PEPP, in our view they offer a superior product with low costs, high transparency and very solid supervision both nationally and via EIOPA. While it's true that some elements of the PEPP hinder a swift uptake (fee-cap, advice) if a provider is able to do so regardless it might become greatly distorting for the pensions market that is currently still expensive.[36]

3.4. When stating that the PEPP is hardly a 'traditional initiative', some other elements of the PEPP deserve mentioning. For a long time, there has been a clear distinction in legal discourse[37] over the position of pension provisions amongst three pillars.[38] If it's state funded it's a first pillar product, if it's via an employer second pillar and an individual product is considered third pillar.[39]

However, as the notion of 'pillars' is already prescriptive (it's not suited to describe systems) it's hard to use it for comparison between countries. On a macro level, this isn't too problematic, as for example the statement 'country X has a strong second pillar which is stronger than country Y' is a valid comparison. However, this statement seems problematic when designing pan-European pension products with a cross-border element. For example, article 6 of the PEPP Regulation enables Institutes for Occupational Retirement Provision to offer the PEPP, as long as their national law enables them to offer personal products. However, as some countries differ in their view which entity 'fits' in the 'second pillar', this might lead to the situation that a Dutch IORP is excluded from offering a PEPP while a, for example, Luxembourg ASSEP (a DC IORP) isn't.[40] Things get even more complicated when, for example, a Luxemburg IORP offers a PEPP with a Dutch sub-account.

Legally speaking, the answer is not so simple. For cross-border provision, IORPs are regulated via article 15 of the PEPP Regulation. If a PEPP provider wants to access a different market for the first

time, the home and host competent authority need to communicate and the sub-account is in accordance with the Regulation, in particular according to article 6 of the PEPP Regulation. However, the Regulation does not offer the possibility to deny PEPP providers such as IORPs their right of freedom of services. According to the applicable rules ex article 3, the PEPP Regulation is applicable as well as the relevant sectorial Union law, laws adopted in implementation of relevant sectoral Union law and measures relating specifically to PEPPs and other national laws which apply to PEPP. However, as the Regulation specifically governs the topic of distribution and enables IORPs that are authorized under their national law to offer the PEPP, there doesn't seem much space to exclude them from other markets that do not allow IORPs to offer personal pension products. The recitals of the PEPP state clearly that

"Under the freedom to provide services or the freedom of establishment, PEPP providers can provide PEPPs and PEPP distributors can distribute PEPPs within the territory of a host Member State after opening of a sub-account for that host Member State."

Alternatively, one may argue that implementing rules on a national level falls under measures specifically relating to PEPPs, thus enabling Member States to exclude IORPs from operating in their territory, but also keeping in place barriers for the internal market.[41]

However, regardless the possibility of classical occupational vehicles to offer the PEPP, a major and often unnoticed element of the PEPP is that it is not individually bought by definition.

Article 2(2): …subscribed to by a PEPP saver, or by an independent PEPP savers association on behalf of its members…

In theory, employers are able to set up an opt-in PEPP scheme (see also the point on borderline case) for their employees, which wouldn't be offered directly by the employer, but rather incentivized as an extra benefit in the terms of employment. The requirement of being independent could be solved by empowering social partners to set up such an opt-in scheme. The great flexibility for switching PEPP providers against marginal fees would enable the PEPP consumer to move away after retirement.

4. The EU has several 'pension problems, for example ageing, poor portability and the lack of consumer protection. Furthermore, the EU internal market for pensions is not sufficiently developed. This not only prevents, for example, a cost-efficient pension build-up of an employee working abroad, but the differences among national rule also restrict a local pension participant in choosing a pension fund established abroad.

The PEPP can help break down these barriers as well as contribute to a high level of consumer protection, for example via limiting the costs and providing detailed information requirements. This article contains a description on the PEPP and its consumer protection elements, potential uses and its Level 2 measures.

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