Pension Notes

No. 62; April 2022

Europe expands individual funding to improve pensions: the implementation of the "Pan-European Personal Pension Product" (PEPP)

Federación Internacional de Administradoras de Fondos de Pensiones

Executive Summary

At the end of March 2022, the so-called "Pan-European Personal Pension Product" (PEPP), which constitute a common voluntary cross-border pension savings market, came into effect in Europe. Europe thus continues to expand individual funding to ease pressure on the public finances of its member States faced with rapidly ageing populations, and to achieve pension systems that are more financially sustainable and provide better pensions for its workers.

The PEPPs, which can be established in any of the Member States of the European Union (EU) or the European Economic Area (EEA) and are accessible to all their citizens (whether dependent or self-employed), are a new option for citizens to actively save for retirement, encouraging voluntary private savings and complementing the sources of income for withdrawal from the ailing PAYGO systems and the mandatory individually funded occupational systems. The European Commission estimates that this new product will boost long-term savings, and that assets managed throughout the EU individual pensions market could triple to USD 2,320 billion by 2030.

One of the advantages of PEPPs is that in addition to addressing the long-term sustainability of public PAYGO pension systems in EU countries, it will benefit workers through more portability options, greater competition, and more transparent and flexible product options, at a limited cost. Pension providers will also benefit from a single market and more efficient cross-border distribution, enabling them to create economies of scale. Finally, these products will contribute to channeling more savings towards capital markets and providing additional capital for long-term investment in the real economy, thus promoting higher economic growth in the EU.

Although PEPPs offer clear benefits from a conceptual standpoint, there is uncertainty regarding their design and practical implementation. The industry looks forward to receiving further information from EU legislators regarding their design, as they proceed with their implementation.

Considering population aging in other continents, the unsustainability of public PAYGO pension systems and the need for greater savings to finance adequate pensions, one would imagine that future public policymakers would address the feasibility of establishing a common market for voluntary cross-border pensions in other jurisdictions.

Introduction

As explained below, Europe continues to expand individual pension savings, this time through a common market for voluntary cross-border pension savings (Pan-European Personal Pension Products, PEPPs). The main reason is that this type of voluntary pension saving is a fundamental part of the construction of adequate pensions, in the light of population aging. The European Union (EU) has stated that it encourages these schemes to offer people more savings options and provide them with more competitive individual pension products with which to save for their retirement, with strong consumer protection.

This Pension Note describes the main features and potential benefits of this new product for European countries to improve their pension offers.

I. Why is Europe expanding individually funded pension savings and what are PEPPs?

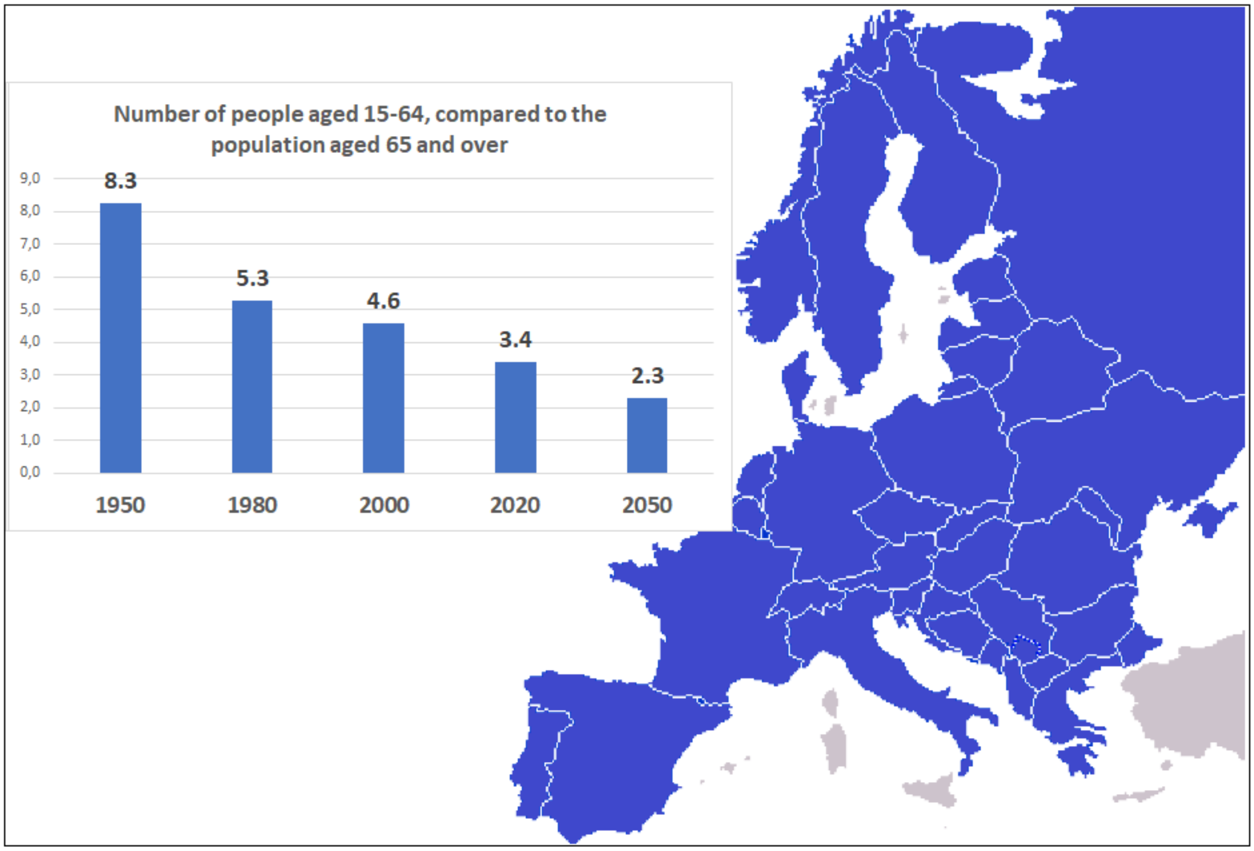
Due to population aging, driven by greater life expectancy at retirement and plummeting birth rates, the outlook for financing the pensions granted by the PAYGO systems has become increasingly critical, because there will be progressively fewer active workers to finance the pension of each senior citizen. According to United Nations data[1]the number of people aged 15-64, compared to the population aged 65 and over in Europe, was 8.3 in 1950. This ratio dropped to 5.3 in 1980, to 4.6 in 2000, and to 3.4 in 2020. This ratio is projected to reach 2.3 by 2050 (see Figure 1). Thus, over a period of 100 years, the number of people of retirement age vs the working population will almost quadruple, so if no adjustments are made to the PAYGO systems, pension amounts will drop to one quarter, or else the contribution rate will have to be multiplied by four to maintain pension amounts. This tremendous demographic change has made it essential to carry out pension reforms to stimulate individually funded mechanisms, to relieve pressure on public finances and achieve pension systems that are more financially sustainable and provide more adequate pensions to workers.

This is why the PEPPs were created[2]on March 22, 2022, as a new option for EU citizens to actively save for retirement, encouraging voluntary private savings and thus complementing the sources of income for withdrawal from the public PAYGO and mandatory individually funded occupational schemes. EU member countries have until June 2022 to incorporate them into their legal systems.

[1] Source: "Potential support ratio (15-64/65+) by region, subregion, and country, 1950-2100 (ratio of population 15-64 per population 65+)", World Population Prospects 2019, United Nations.

[2] This new product is governed by the Regulations of the European parliament 2019/1238

Figure 1
Europe: Population aging reaches critical levels



Source: FIAP based on "World Population Prospects 2019", United Nations.

PEPPs offer EU citizens a new voluntary cross-border pension savings product[3], which may be established in any of the Member States of the EU or the European Economic Area (EEA) and accessible to all its citizens, whether employed or self-employed.

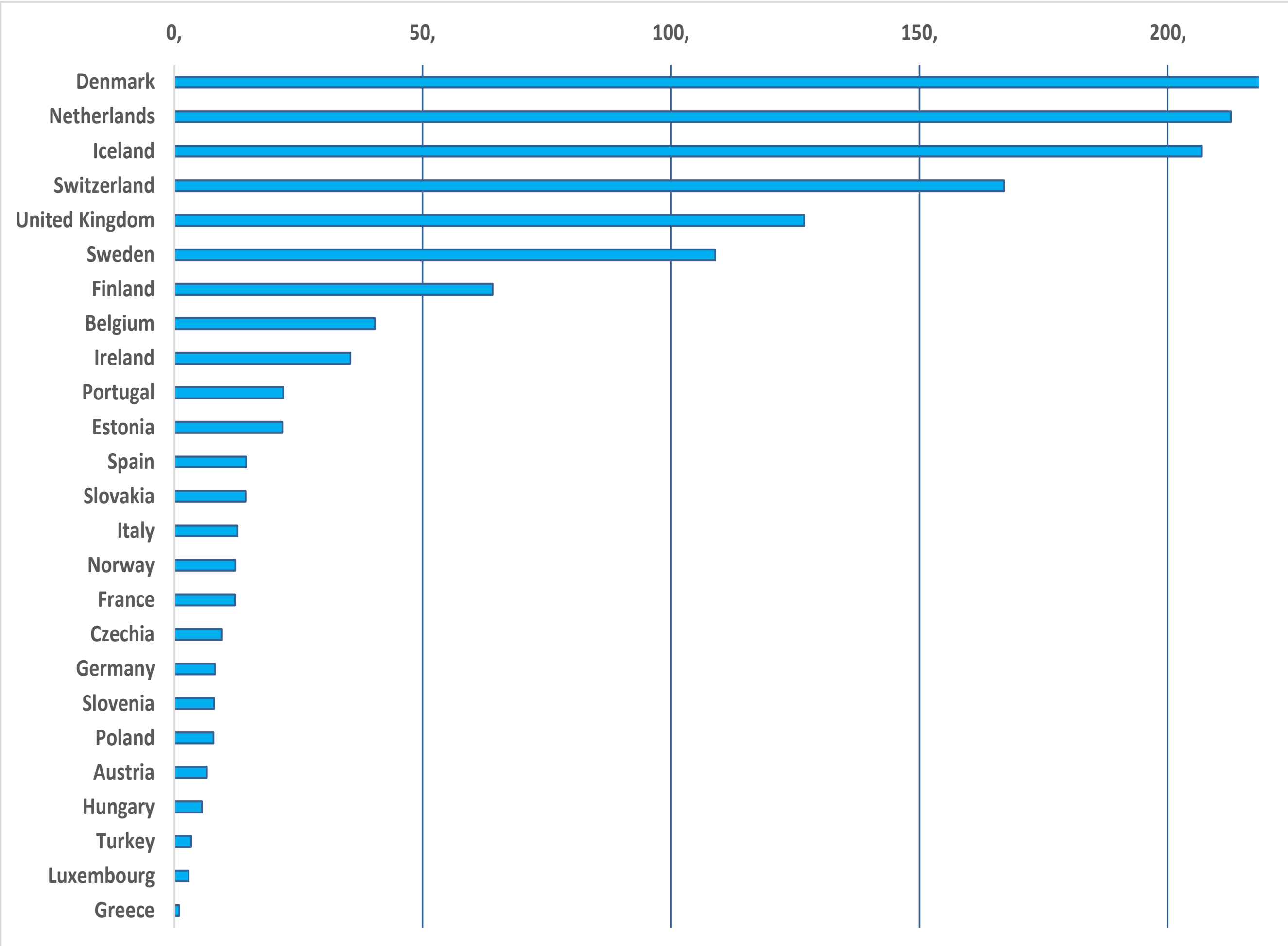
This new product will be particularly relevant in those EU markets that have traditionally lacked a strong pension industry, as in Southern and Eastern Europe, where individually funded pension funds are relatively low as a % of GDP (below 50% of GDP; see Graph 1).

As shown in Figure 2, the European Commission estimates that this new product will boost long-term savings, and that assets managed throughout the EU individual pensions market could triple to EUR 2,100 billion[4] (approx. USD 2,320 billion) by 2030.

[3] The use of PEPPS has not been introduced as a directive, but rather as secondary regime regulations, so EU Member States should apply them as such.

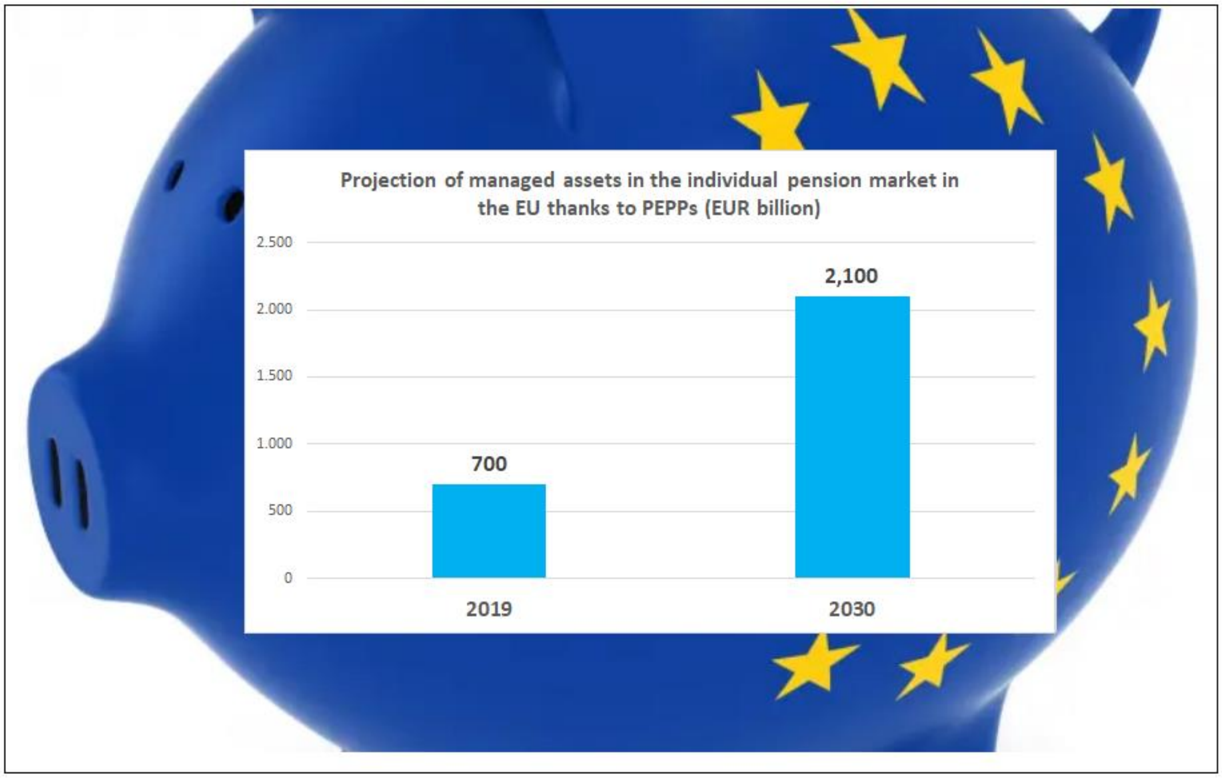
[4] Refers to the nomenclature "billion" (English; one thousand million).

Graph 1
Individually funded pension funds as a percentage of GDP in selected European countries (2020)



Source: FIAP based on "OECD Pension Markets in Focus 2021".

Figure 2



Source: FIAP based on the Opening speech by the Vice-Chairman of the European Commission, Valdis Dombrovskis, at the Baltic and Nordic Conference, April 23, 2019: "Impact of the PEPPs on EU capital markets and sustainable pension revenue." Available on YouTube: https://www.youtube.com/watch?v=QNgMhepyR4g

II. Benefits of PEPPs

According to the experts and the European Commission itself, the PEPPs:

(i) Will help to address the long-term sustainability of public PAYGO pension systems in EU countries, through greater individual responsibility for building workers' pensions. “As a complement to public pensions, the PEPPs respond to the needs of today's younger generation and make it easier for people to plan better and make arrangements for the future,” emphasizes Mairead McGuinness, Commissioner for Financial Services, Financial Stability and Capital Markets Union.

(ii) An important savings tool is made available to the growing number of self-employed or independent workers.

(iii) Savers will benefit from additional choices, greater competition, and more transparent and flexible product options.

(iv) Pension providers will benefit from a single market and more efficient cross-border distribution, enabling them to pool assets and create economies of scale.

(v) They will contribute to channeling more savings towards capital markets, thus promoting higher economic growth in the EU.

III. Main characteristics of PEPPs

(i) **Trading entities**: Like other financial and savings products, PEPPs can be marketed by financial institutions, insurance companies, asset managers, banks, investment firms and certain occupational pension funds. To be able to do so, they must be registered in a central registry kept by the European Insurance and Occupational Pensions Authority (EIOPA). After registering, PEPP promoters and distributors will have a passport that will allow them to sell their pan-European pension product in different countries of the European Union with a single product registration.

(ii) **Portability**: This will allow savers to continue contributing to their PEPP, even if they change their place of residence to another EU country. If the PEPP provider does not offer this option in the new country of residence, the saver shall be entitled to change PEPP provider immediately and free of charge. Thus, PEPPs are a cross-border product, and consumers can benefit from a single consolidated pension wherever they work and whenever they change their place of residence.

(iii) **Flexibility**: Savers may also change their PEPP provider, even if they do not change their country of residence. This may be done five years after they start saving. They can also change their PEPP provider again 5 years after the change, although each PEPP provider can specify the terms of this time window. Furthermore, the EU stipulates in the Regulations that the fees and expenses for this change should be limited to administrative costs and should not exceed 0.5% of the value of the transferred assets.

(iv) **Transparency**: A PEPP developer is required to disclose detailed information to consumers through a pre-purchase "key data document." PEPP providers must also provide a "personalized pension benefit statement" during the product lifecycle.

(v) **Investment Options**: These savings products will have up to 6 investment options, including the default option, called "Basic PEPP." PEPP savers may change their investment option free of charge from time to time, after a minimum of 5 years from the subscription of the PEPP contract, and thereafter 5 years from the date of the most recent change of investment option, although each sponsor may change the duration of this time window.

(vi) **Decumulation options (payment of pensions)**: Like other savings products, PEPPs may be collected as principal or via programmed withdrawals. Each country will determine the tax status of these new savings products to supplement retirement.

(vii) **Consumer Protection:**

a) **Basic PEPP for capital protection**: In this option, promoters have the duty to protect the capital of savers, by means of a guarantee, or through risk reduction techniques. Furthermore, basic PEPP expenses and fees may not exceed 1% of the accumulated capital per year.

b) **Personalized advice**: One of the main PEPP innovations is that promoters and distributors must offer comprehensive advice to their customers before enrolling them. The EU's objective is for savers to have all the information necessary to make a fully informed decision and to choose the product that best suits their needs. Hence, prior to the subscription of the contract, savers should receive key product information through a key information document. They must also receive a yearly PEPP benefits statement with comprehensive data on the evolution of their savings. Expense and fee information must also be transparent.

IV. Some preliminary considerations for pension providers and custodians in the implementation of PEPPs

According to BNY Mellon (2022)[5], whereas PEPPs offer clear benefits from a conceptual standpoint, there is still much uncertainty regarding their design and practical implementation. The industry looks forward to receiving further information from EU legislators regarding their design, such as the proposed cross-border tax treatment for PEPPs in the context of heterogeneous national tax regimes.

Meanwhile, there are some key preliminary considerations for two distinct groups of market participants as they proceeded to the implementation of PEPPs.

A) For pension plan sponsors and providers

The commercial potential of PEPPs is still uncertain, but there are several key points that market participants should consider.

From a sponsor's perspective, PEPPs offer an attractive solution for multinational companies that need to consider cross-border pension solutions for their workers, and for companies in jurisdictions lacking robust pension provision.

PEPPs create a new savings product for plan providers, that can be approved across Europe and possibly in other countries, based on regulatory equivalence. Given their experience in investment fund management, insurance companies and investment managers, both within and outside the EU, appear to be natural PEPP providers.

[5] https://www.bnymellon.com/us/en/insights/all-insights/why-europe-is-creating-a-new-path-for-retirement-savings.html

Additional points to consider include the following:

a. There is likely to be a demand for “green PEPPs”, driven by younger generations working across borders. This will benefit institutional investors with strong responsible investment credentials (Environmental, Social and Corporate Governance factors, ESG).

b. PEPP providers can focus on Southern and Eastern European countries as new growth markets. Distribution partnerships with regional institutions could be an important development feature.

c. Providers can choose traditional fund markets such as Ireland and Luxembourg to launch a PEPP, but they can also consider other developed EU jurisdictions. The Netherlands, for example, has a strong pension tradition and will give providers access to an occupational pension market, an experienced regulator, and local providers with a pension focus.

d. Providers should bear in mind the 1% annual fee cap on the fund saved for the BASIC PEPP and the mandatory requirement to provide personalized advice to their members. These reflect efforts to protect users, but may be potential barriers to market entry.[6].

e. With a view to cost-effectiveness and user experience, providers can take advantage of existing practices in the wealth management industry, including robo-advisors.

B) For custodians

PEPPs do not differ in principle from the fund structures currently managed by custodians. In practice, this means that custodians can position their basic fund services offer to support PEPPs through custody and fund accounting. However, PEPPs include some components that will enable custodians to provide additional value-added services, such as ESG data, analytical services and customized monitoring and compliance reporting. Other areas where custodians can play an important role for PEPP providers include:

(i) **Cost Control**: Transparency is key with regard to PEPPs costs, and custodians can provide the tools needed to track and control them.

(ii) **Depositary**: While PEPP legislation does not provide for the mandatory designation of a depositary, some industry participants argue that an independent "second line of defense" is recommended to protect consumers. In this regard, it is worth mentioning that EU law provides that the depositary should be appointed in the jurisdiction of registration, but the freedom of services allows the depositary to offer its services throughout the EU.

[6] In other words, the provider is required to have a certain minimum scale for its commercial success with PEPPs.

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Queries: International Federation of Pension Fund Administrators (FIAP).
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