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## **WORKING DOCUMENT**

on the proposal for a regulation of the European Parliament and of the Council on a pan-European Personal Pension Product (PEPP) (COM 2017/0343) and the Commission Recommendation on the tax treatment of personal pension products, including the pan-European Personal Pension Product (C 2017/4393)

Committee on Economic and Monetary Affairs

Rapporteur: Sophia in 't Veld

## **I BACKGROUND**

### ***Introduction***

Old age pensions constitute an essential part of a retiree's income, and for many people an adequate pension provision makes the difference between a comfortable old age or poverty. It is a precondition for exercising fundamental rights laid down in the EU Charter of Fundamental Rights, not least Article 25, the rights of the elderly: "The Union recognises and respects the rights of the elderly to lead a life of dignity and independence and to participate in social and cultural life".

In addition, as a substantial part of old age pensions are provided under public schemes, there is also a direct connection between pensions and the sustainability of public finances. Notwithstanding the exclusive national competences regarding the organisation of pension systems as determined by the EU Treaties, income adequacy and financial sustainability of national pension systems are crucial to the stability of the European Union as a whole, and of the euro area in particular.

Finally, pension savings contribute to the Capital Markets Union, and thus to the economy of the European Union.

Europe is facing several challenges. Demographic challenges: Europe is an ageing continent. In addition, career patterns, the labour market and the distribution of wealth are undergoing radical changes, not least as a result of the digital revolution. At the same time, it is increasingly clear that national security systems are not adjusted to a globalised knowledge economy with open borders, labour mobility and migration. Too many people are not, or inadequately covered by the traditional national pension systems: women, young people, migrants, low-skilled workers, self-employed workers, workers with atypical contracts etc.

Most EU Member States are conscious of the challenges, and in recent years they have introduced far-reaching reforms of their national pension systems. But more is needed. In its 2017 Pensions at a glance report, the OECD states that "even taking into account the progress that has been made, concerns about the financial sustainability and pension adequacy of the current state of pension systems in OECD countries remain [...] Continued ageing of societies combined with the changing nature of work puts pressure on both the financial sustainability and the retirement income adequacy of pension systems; in addition, risks of increasing old-age inequality have been building up. [...] Public expenditure on pensions as a percentage of GDP has increased and is expected to rise further in the near future in most OECD countries. [...] At the same time, recent reforms will lower replacement rates in many countries due to measures aimed at improving pension finances. This may jeopardise the adequacy of retirement income in some countries, especially for retiring low-skilled and low-paid workers. The long term need to reform is still present in many countries, especially given the ongoing improvements in longevity".

Priority must be given to further developing, strengthening and reforming the first (public) and second (occupational) pillars of the pensions systems. However, it is expected that the share of first pillar pay-as-you-go public pensions as part of the replacement rate will decline. This may be partly compensated by entitlements from second pillar funded schemes. But a

well-developed third pillar can and must contribute substantially to improving the adequacy and sustainability of the existing pension systems. The Pan-European Personal Pension Product may complement and strengthen the market for individual pension products across Europe.

The European pension market is highly fragmented and diverse, so the impact of PEPP will be very different across Member States, and the target audience is equally varied. In countries where the first and second pillar are insufficiently developed, PEPP may offer solutions for people who do not currently have access to adequate provisions. In countries with highly developed pension markets, the PEPP may simply broaden the consumer choice, or offer solutions to mobile citizens, roughly 3.7 % of the Europeans who work and live in another Member State. At the same time, PEPP creates new business opportunities for providers of personal pension products in Europe.

Therefore, PEPP must meet various criteria. It must be a safe, reliable, consumer friendly retirement savings product with cross-border portability. It must offer options that meet the needs of people ranging from those who are not financially literate and with very limited means, who need PEPP as their basic retirement income, up to those who are looking for alternative products to broaden their retirement provision.

PEPP must be attractive to the providers as well. As PEPP will be a voluntary retirement provision, it has to compete with existing personal pension products in well developed markets, and at the same time it has to conquer new markets. In countries with lesser-developed pension markets the PEPP can provide a trusted retirement provision with a European label.

There is broad support for the idea of PEPP, but the context is extremely complex and politically sensitive. The differences between 28 Member States of the EU are huge and intricate. Regulatory and fiscal rules differ widely, the features of the national pension systems, the state of development of first and second pillar provisions, national traditions and the state of the economy are all so different, that no two Member States are the same. The range of possible providers is very wide, and each sector is subject to different regulatory regimes of both national and international rules. The potential consumers are just as wide ranging, as described above.

However, the status quo is not an option. The concerns about insufficient adequacy and sustainability of pension systems oblige Europe to develop initiatives. But also the arrival of new market actors, in particular FinTechs and internet giants from outside the European Union, offering new financial products on the European market. At the same time, the single market for third pillar personal pension products has not reached its full potential, as many national fiscal and regulatory hurdles remain.

For the reasons set out above, the proposal for PEPP is timely and appropriate.

### ***PEPP proposals and procedure***

The Commission proposes a Regulation on PEPP, accompanied by a Recommendation on the fiscal treatment of PEPP. Your rapporteur supports the choice of a regulation as the most appropriate instrument. The Regulation essentially regulates the product, not the providers. This will enable the provision of PEPP anywhere in the EU.

PEPP will be a voluntary third pillar retirement product, with an explicit retirement objective, based on a contract between an individual and a non-state based entity.

Finding the right degree of harmonisation of PEPP features will be a key challenge. On the one hand maximum harmonisation is required in order to achieve the economies of scale, to ensure portability and switching, and to create a true European market. At the same time, maximum harmonisation of PEPP features will make it more difficult for PEPP to qualify for favourable tax treatment in the Member States and to fit into national regulatory schemes.

Given the complexity and sensitivity of this file, your rapporteur believes close cooperation within and between the EU institutions, and with all stakeholders is essential for PEPP to succeed. Additionally, your rapporteur believes the use of delegated or implementing acts should be limited to a strict minimum, so as to ensure maximum clarity and legal certainty.

## **II KEY ISSUES**

This chapter lists some of the main issues and dilemmas to be discussed, with a view to drafting a report and amendments in the ECON committee. The list of issues clearly is not exhaustive, but meant to focus the debate on some of the main policy choices. The working document does not express the definitive position of your rapporteur, but it explores various avenues and possible solutions.

### ***1. Fiscal treatment***

The study by Ernst & Young carried out at the request of the European Commission (FISMA/2015/146(02)/D) demonstrates very clearly that tax incentives on in-payments are a pre-condition for PEPP to succeed. It actually appears to be the "main driver for consumer choice".

Two objectives seem to be diametrically opposed: the need for harmonisation in order to make PEPP an attractive product, and the heterogeneity of the national conditions for a tax break.

Although nearly all Member States provide tax incentives for individual pension saving, the conditions for favourable tax treatment, and the form in which it is granted, vary enormously from Member State to Member State. In most Member States the in-payments for personal pension products benefit from a tax incentive, whereas the out-payments in the decumulation phase are subject to taxation.

Taxation is a purely national competence, so it is exclusively up to national governments to decide on any tax incentives for PEPP. At the same time, free movement of persons, services and capital must be guaranteed. Given the crucial importance of this aspect, your rapporteur will seek close consultation and cooperation with Member States on this matter, and seek to further elaborate the Recommendation of the Commission, and provide a common basis for Member States to move forward on.

It is highly unlikely to achieve unanimity for any kind of tax harmonisation among the Member States. But alternative avenues can be explored. A group of Member States could agree to advance on the basis of a voluntary multilateral approach. Harmonisation or approximation can be achieved in various ways. If PEPP has certain agreed features, it could

receive the same beneficial treatment as national products, or alternatively Member States could agree on a specific "29th regime" approach, allowing for a specific tax treatment for PEPP.

Regardless of the form of the tax break, what is essential is for PEPP to benefit from a fiscal treatment that will make it attractive to consumers and that is equivalent to the tax treatment of national products. This means in most cases a tax incentive must be given for the in-payments phase for PEPP to be able to compete.

However, there is a dilemma. A tax exemption during the accumulation phase has a number of risks and disadvantages for the Member States in the case of mobile customers: the complexity of cross-border tax administration and the risk of tax avoidance or evasion. It is crucial that this is resolved, possibly in a multilateral tax agreement between participating Member States, or with EU instruments regarding information exchange and coordination. It should be borne in mind though, that the number of cross-border mobile workers in the EU is limited (3,7% of Europeans), and only part of them is likely to take out a PEPP.

## ***2. Eligible providers***

Article 5 of the draft Regulation lists six types of providers that may be authorised to offer a PEPP.

The proposed financial institutions are regulated by different EU instruments, for example, CRD IV, Solvency II, IORP, MiFID, IDD, UCITS and AIFM. Considering the diversity of applicable regimes, every effort must be made to ensure a level playing field for providers, and clear and even rights of PEPP users regardless of the type of provider.

The Commission proposal includes IORPs as eligible PEPP providers. An IORP typically provides second pillar occupational pensions. However, some EU Member States have systems based on mandatory auto-enrolment, with exclusive rights for IORPs to provide occupational pensions. In those countries the legislator has chosen to confer those exclusive rights onto the IORPs, considering that retirement provision is a matter of general interest to society. The PEPP Regulation should not in any way jeopardise well developed second pillar systems. That would be defeating the very purpose of PEPP. Moreover, IORPs with exclusive rights have a competitive advantage over other providers, such as insurers. Unqualified inclusion of IORPs might as a result lead to a distortion of competition.

However, the categorical exclusion of IORPs from Article 5 would reduce competition and choice, and exclude institutions that have extensive experience in the area of retirement provision. It may therefore be considered to exclude IORPs only in those cases where it would manifestly undermine existing second pillar systems. Article 5 may be redrafted in such a way that only IORPs with a legal statute that allows them to engage in commercial activities can be eligible, and that activities of IORPs under the mandatory auto-enrolment regime can be ring-fenced or separated from PEPP activities.

## ***3. Portability***

A personal pension product can only really, truly be pan-European if there is full portability. The portability of PEPP relies to a large extent on the elimination of regulatory and fiscal barriers between Member States, but also on the portability services offered by the providers.

With regard to the portability service, the Commission proposes in Article 13(3) that compartments must have been set up in all Member States within three years after entry into force of the Regulation. That may be desirable but probably not feasible. Such an obligation would constitute a big hurdle for smaller, regional providers, as costs would be prohibitive.

A possible solution would lie in partnerships between providers in different Member States. However, if a provider chooses not to offer compartments in all EU Member States, they must inform users clearly and pro-actively of the availability of compartments in Member States before a contract is signed. The number of compartments laid down in the contract must be binding for the providers.

In addition, EIOPA can play an important role in boosting portability of PEPPs by facilitating the creation of new compartments with information kits on national requirements, and by assisting providers in finding partners through a register of available partners.

Finally, additionally to the proposed PEPP Pension Benefit Statement, initiatives for an EU wide pension tracking system that allows each person to get a complete picture of his accumulated pension entitlements, will further facilitate PEPP portability.

#### ***4. Capital protection***

PEPP will be a new product on the market. It will have to be both attractive and trusted by consumers and providers. The Commission proposes that providers should offer up to five PEPP investment options, including a Default Option. Providers may also offer the option of coverage of biometric risks.

Some parties have suggested to scrap the obligation of offering a default option, and treating all investment options as equal. This may be indeed more attractive for providers, however, your rapporteur feels a simple and safe Default Option must be offered in the interest of consumers. This question is of particular relevance if the Regulation allows for the conclusion of PEPP contracts without advice.

Article 37 of the proposed Regulation states that the default investment option of the PEPP shall ensure capital protection for the saver, based on a risk-mitigation technique that results in a safe investment strategy. However, it remains unclear if the Commission's proposal requires a default option with a capital guarantee. Based on the text of Article 37 the default option can be either a capital protection, or a life-cycle investment strategy. The Commission proposes to specify the risk-mitigation techniques, including the definition of "capital protection" for the default option, in a delegated act. Your rapporteur however, recommends that these notions be defined in the Regulation itself, for the sake of transparency and legal certainty.

A capital guarantee lifts the investment risk from the saver to the provider, giving the saver a high degree of certainty over their investment. However, the safety of a guarantee has the downside of being expensive, and providers will generally invest via low risk/low return investment strategies. Furthermore, not all providers will be able to offer capital guarantees. Institutions under the prudential regime of Solvency II will generally be able to offer such a product, but other institutions e.g. IORP's may not be able to acquire sufficient capital to offer unconditional guarantees. This may potentially hinder those institutions from entering the market, reducing competition.

A life-cycle investment strategy does not provide a capital guarantee, but it generally provides for a better investment result because the risk mitigation generally sets in a number of years before the retirement age. Most assets in life-cycle strategies are invested in higher risk/higher return assets, with a switching mechanism to more conservative investments shortly before retirement. Since the PEPP is a long term savings product, the accumulated investments have time to grow, which is in line with the goal of establishing a CMU.

One possible compromise is having two ‘defaults’. This would mean that two standard products would be offered, one providing a capital guarantee, one providing a life-cycle investment strategy. However, two default options seems to be a contradiction in terms. Another solution might be a mix of both options.

### ***5. Decumulation phase and out-payment options***

Conditions for the decumulation phase will generally be determined by national legislation. The Commission does not propose harmonisation. The form of out-payments - annuities, lump-sum or drawdown payments or a combination of these - may be chosen by the saver upon conclusion of the contract with the provider, and adapted once every five years during the accumulation phase. Having multiple pay-out options may also be beneficial for making a PEPP ‘truly European’, since it allows savers to tailor the payment to their needs, regardless the degree of development of the pension system of their Member State.

However, given the policy objective of PEPP to contribute to improving retirement income adequacy, financial stability and to reducing retirement inequalities, and also given the objectives of portability and switching, a degree of harmonisation of the decumulation features might be considered, at least for the default option. For example a minimum percentage to be paid-out in annuities. Early out-payments should in any case be limited to exceptional situations, to be determined by the Member States.

It must be noted though that both scenarios - no harmonisation or minimum harmonisation of the decumulation features - will have consequences for the tax treatment and for the investment strategies, in particular if the form of out-payments could be changed without limitation.

### ***6. Switching***

Switching enables the saver to transfer the accumulated capital from one PEPP-provider to another. In the Commission’s proposal the frequency of switching is fixed to every five years. Allowing savers to switch providers gives them the opportunity to look for the best performing provider, while also protecting the provider from sudden large withdrawals when investing in non-liquid assets.

The possibility of switching only every five years might be a deterrent to some savers while considering a retirement’s savings product, while also limiting competition to some extent. On the other hand, five years might be too short for certain investment strategies, limiting providers in offering a suitable product.

Clearly the wide range of eligible providers from very different sectors ruled by different regulatory regimes, across different national systems, makes the objective of switching one of the most complicated ones.

## ***7. Information, advice, costs and consumer rights***

Given that "trust" must be the key word, information on the product to consumers, and protection of their rights must be an essential feature of PEPP. The Commission has proposed a specific PEPP KID (Key Information Document). However, as providers fall under different regulatory regimes, each with its own information requirements, care must be taken not to duplicate, or make information to consumers unnecessarily complex and costly. The information for the default option in particular, should be simple and accessible for a very broad audience, including people with limited financial literacy.

Costs must be kept as low as possible. This must be a guiding principle when drawing up the Regulation, but also in the context of application by national authorities. Digital provision of all services in the chain, including information, advice, conclusion of contracts and complaints and redress procedures, will help keeping costs low. At the same time, there must be safeguards for those who are unable to make use of digital means, in particular with regard to the default option.

A pan-European product with the options of cross-border portability and switching, clearly requires a single, harmonised PEPP Benefit Statement. It would also require pan-European consumer protection rules, and a single, harmonised complaints and redress procedure. National procedures, as proposed by the Commission, will be inadequate in case of PEPP holders who have an account in several compartments. It may be considered instead to task EIOPA with setting up a one-stop-shop mechanism for complaints and redress by coordinating the responsible national authorities (analogous to the GDPR mechanism). Such a mechanism could also include a procedure for collective redress by PEPP users across Member States.

Finally, your rapporteur is not convinced that the Commission should, as proposed in Article 28(2), create its own exclusive powers to set the rules determining the assumptions on pension benefit projections.

## ***8. Authorisation, supervision and review***

For PEPP to be a truly European product, and to gain the trust of consumers and providers alike, a European label based on a European authorisation procedure and uniform, high standards of enforcement and supervision throughout the European Union are a prerequisite. This should be achieved through common standards, and coordination of national supervisors by EIOPA. PEPP will be as strong as the weakest link in the chain.

National supervisors are close to the local market and to national authorities. They will supervise the providers. However, authorisation of a PEPP should get the stamp of approval of EIOPA, so as to create a brand known and trusted throughout the EU.

What has to be clarified in more detail, is the liability of both national supervisors and the ESA, in case of problems with a PEPP.

For the purposes of the evaluation proposed in Article 63, it may be considered to set up a stakeholders panel to monitor on an ongoing basis the functioning of the Regulation and the development of PEPP.