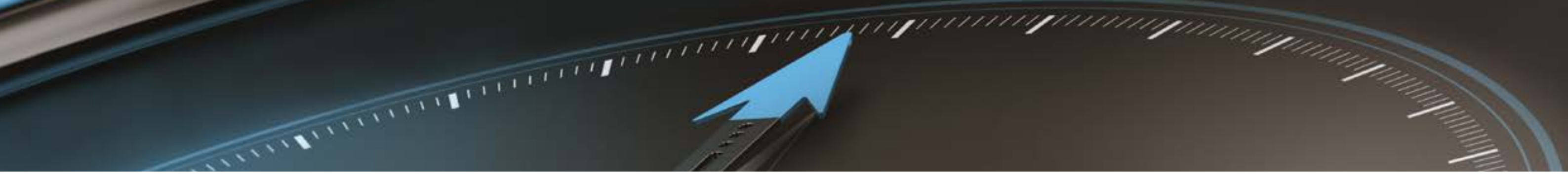
The PEPP:

The biggest change to Europe’s investment industry for a generation?

IFI Global



Introduction

The EU's proposed pan European pension product (PEPP) could well turn out to be the most significant change to the Europe's investment landscape since UCITS arrived on the scene 30 years ago. But like the original UCITS Directive it will probably be some time before its impact is felt.

Nonetheless things are moving quickly: the European Commission published its proposals for the PEPP just over a year ago, in June 2017. Since then investment managers, insurers, industry bodies as well as various people within the Commission and EU Parliament have been trying to get to grips with the issues that need to be addressed before the PEPP can be rolled out.

The Tracker will be following these developments in future. That is because the PEPP will almost certainly have a really substantial impact on future fund industry structures. The Tracker has begun its coverage by hosting a roundtable on this topic, which was held in London on September 19.

Participating in the roundtable, which was sponsored by InReg, were: Andy Agathangelou, Chair of the Transparency Task Force and Governor of the Pensions Policy Institute; Bernard Delbecque, Director of Economics & Research at EFAMA; Christian Lemaire, Global Head of Retirement Solutions at Amundi; Dr Bob Swarup, Chairman of the Insurance Investment Exchange; Jean Louis Catrysse, Partner at InReg; Damian Nicell, Marketing Director at InReg and Simon Osborn, Editor of The Tracker and CEO of IFI Global.

The issues that need to be addressed

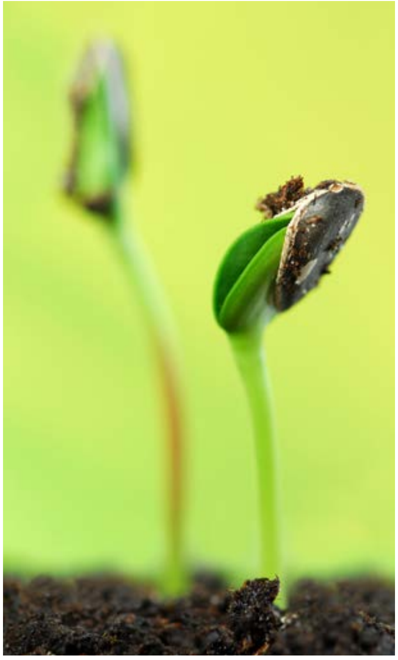
Andy Agathangelou suggested that consumers want the PEPP to happen. It's an opportunity to have a low cost, straightforward, transparent product solution right across the entire European market. There are a lot of practical considerations such as how the PEPP is taxed in different countries to address. There will always be operational friction as a result of the different tax laws in Europe – harmonisation is a very long way off, if it ever happens.

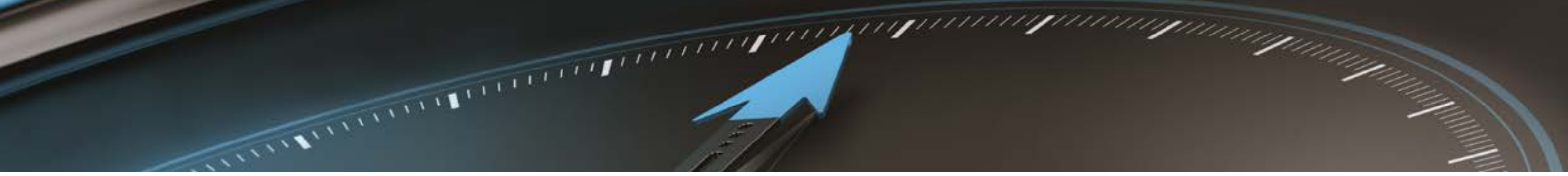
Bernard Delbecque said that we have to have a product that is attractive to both providers and consumers. We have difficulties with the Commission proposal to cover all of Europe because of the tax issue. It has to be attractive to consumers because we are talking about voluntary savings. And don't forget that the PEPP will compete with existing national products; the PEPP will have to have at least the same tax advantages as these national products. There must be choice to savers so that they can select a product that is in line with their particular needs.

Bob Swarup suggested that regulators and policymakers are concerned about future pensioner poverty. The data shows that the replacement of DB by DC was terribly badly done. Research indicates that it was the lack of trust thanks to constant tinkering and the overall complexity that drove consumers away. Savers in the UK avoided pension products and went into ISAs and houses instead, where policy maker interference was perceived to be significantly less. This is what policy makers need to be bear in mind as they move forward with the PEPP.

"We have to have a product that is attractive to both providers and consumers"

– Bernard Delbecque





The capital protection issue

Consumers may want to have the security of capital protection, suggested Bernard Delbecque. But in saving for retirement consumers should be prepared to take some risks. In this low interest rate environment more consumers may come to appreciate the link between risk and return.

Capital protection is a big issue, said Christian Lemaire. Many participants will be attracted to the capital protection element of the PEPP. But with a guaranteed capital protection, there is a risk of relatively low returns, perhaps even below the rate of inflation, ie not a real protection for consumers.

Consumers must be well educated on the issues, he added. For example, if they are willing to take an element of risk when they are younger and far from retirement age, then they can achieve a much better rate of return. A study made by Bocconi, the prestigious Italian University has shown that with these Life Cycle Strategies, the probability of capital protection is 99.9% over 20 years. It should be explained to them that as they are investing over an extremely long term period. Under these circumstances if they are prepared to take on some risk at the early stage then they should do much better in terms of their accumulated total at retirement.

Andy Agathangelou said that the conversation about guarantees is because there is a significant trust deficit in the sector. We have a major policy-making problem in relation to pensioner poverty. We cannot mislead the public in anyway so if we talk about capital protection it must mean real capital protection, taking into account fees and inflation. Anything else would be misleading. Either the capital is protected completely or we clearly point out what the term capital protection actually means, and whether it protects against fees and inflation. It might be possible to protect capital at the point of retirement but not during the accumulation period. If we do not get this right policy makers will be regretting it for a generation.

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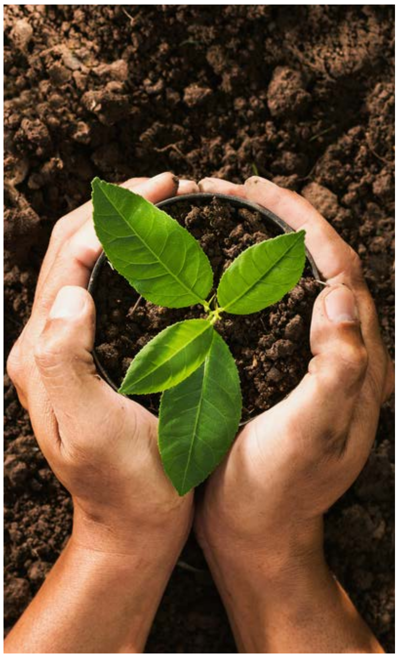
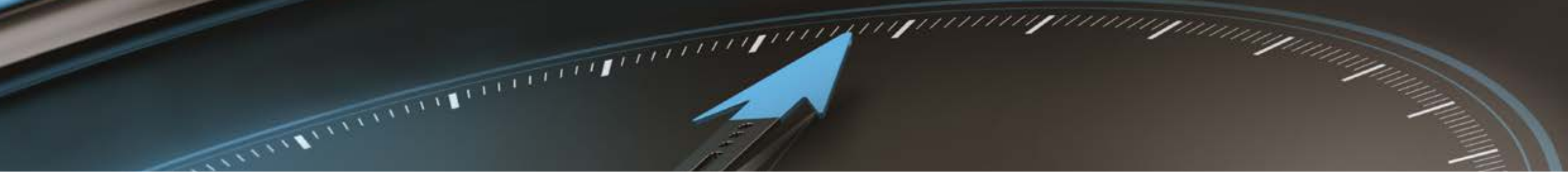


Don't forget margins have been squeezed all round, added Bob Swarup. This needs to be born in mind when one talks about capital protection. Investors have been pushing for lower fees. At the same time, asset managers and insurers have had to spend a lot more to meet their growing regulatory obligations, eg MIFID II and Solvency II.

In this environment, it's not surprising that asset managers decided to prioritise niche products which offer them more fee income, he suggested. For example, asset managers may prioritise a niche alternative fixed income strategy fund that raises them a few hundred million over a core fixed income strategy that might raise a few billion, because the higher fees and lower cost base on the former creates better margins and will generate significantly more revenue despite the smaller size.

The point is that the basic building blocks of a consumer type strategy are not immediately attractive to a lot of asset managers. Meanwhile, most of those in the life assurance industry are worried about their business model. They have many long-dated liabilities, many with legacy issues, and plenty are still haunted by the guarantees that they handed out many years ago. The last thing they want is to go back into that kind of business now.

What consumers want is zero volatility at the end when they get income. The income (from the PEPP) should be stable and in line with projections when people start to draw down. The problem is that asset managers are not set up to meet this mind set. And for insurers, this means long term guarantees, which they are scared of. But you do need a quasi-defined benefit outcome; it's the only way to restore confidence for the consumer. An important reason why people have invested in housing is that they saw that it had a back-stop of perceived value.



Market impact and potential

Jean Louis Catrysse asked what effect the PEPP will have on other investment products, particularly funds. And how will it impact existing local pension products? He also made the point that the investment rules of the PEPP are mainly based on listed financial assets from regulated markets. The idea of the PEPP within the CMU is to drive money to SMEs and to real economic activity.

In response Bob Swarup said to have the money raised by the PEPP invested in SMEs could be problematic, given the higher risk profile and greater opacity. And large parts of the economy that want and need the capital don't have the right mechanisms to get it easily from the retail market.

Andy Agathangelou suggested that the costs associated with being a PEPP provider are perhaps being a little exaggerated. The actual running of the money can be done very efficiently. For example Fidelity has a zero cost offering in the US.

If each offering has to have a physical branch it will become a barrier to market participation, he added. At the moment this is supposed to happen within three years of the PEPP's introduction. I am not in favour of the charge cap as it prohibits competition. But if we don't have a cap we must have complete and total fee transparency on what the true costs are. This must be disclosed in a standardised and consistent way.

He also made the point that he is not concerned about the financial viability of the PEPP as financial services are lucrative if you have the right proposition, brand and cost base. The cost base of the supply side is a key issue as this will not be an attractive market for big old asset managers and insurance organisations that have clunky legacy systems. They are struggling to cope with what they have on already let alone the overlay of a complicated pan European product with complex reporting issues and so forth. It is possible that entities like Google and Amazon will come into this market.

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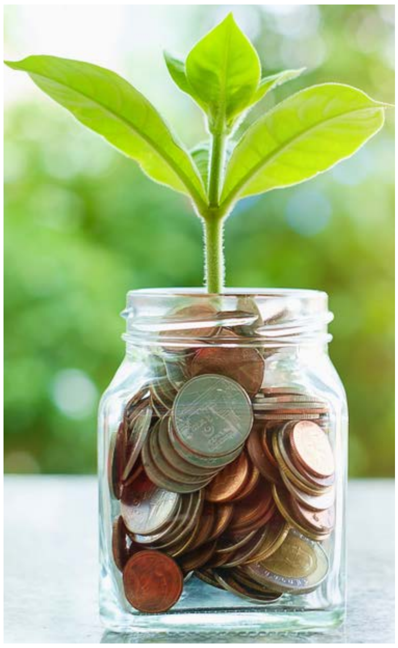
– Andy Agathangelou



How successful will it be?

Bernard Delbecque made the point that we are just at the beginning of a long journey. The same thing happened with UCITS. There will be a slow start to the PEPP as there was with UCITS but if the product is well designed it will work. It doesn't have to be pan European players only that offer the PEPP; it could also be local players offering it in their local market.

How successful it is depends on the weight of the different pillars in each EU member state, he added. It will also depend on the tax treatment of the PEPP in each of the member states too. At the moment we don't know what the outcome of this will be. There might be countries where the PEPP will not take off for years to come yet.

Bob Swarup suggested that the market for the PEPP can grow rapidly but there has to be simple and clear messaging.

Andy Agathangelou believes the potential for the PEPP to do well will largely be a function of how uncompetitive the existing local market is. For example, the markets of eastern Europe are not that advanced or competitive. Their current products are not value for money. They are likely to lose significant market share to the PEPP. But in well developed markets the PEPP may not have much impact because the existing products are well established and strong.

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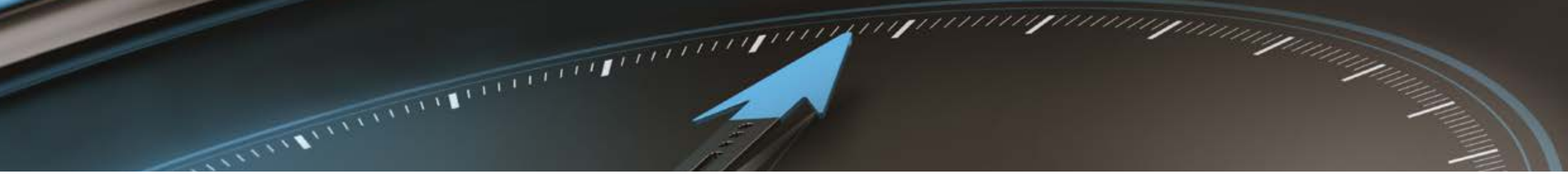
– Bernard Delbecque



Timetable

Christian Lemaire said that the PEPP proposals should be voted on at the end of the year. It is on the European Commission's agenda at the moment. Marketing of it could even start as early as 2020, which is not far off from now. There are going to be many things to prepare for over this short period of time. We all believe it is a good project but we have to wait for the final text.

> "Marketing could even start as early as 2020"
>
> *– Christian Lemaire*

Bernard Delbecque also said that the intention is that the proposals will be adopted by the end of the year under the current EU parliament and Austrian presidency. From that point onwards the industry should be able to start preparing for its development.

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