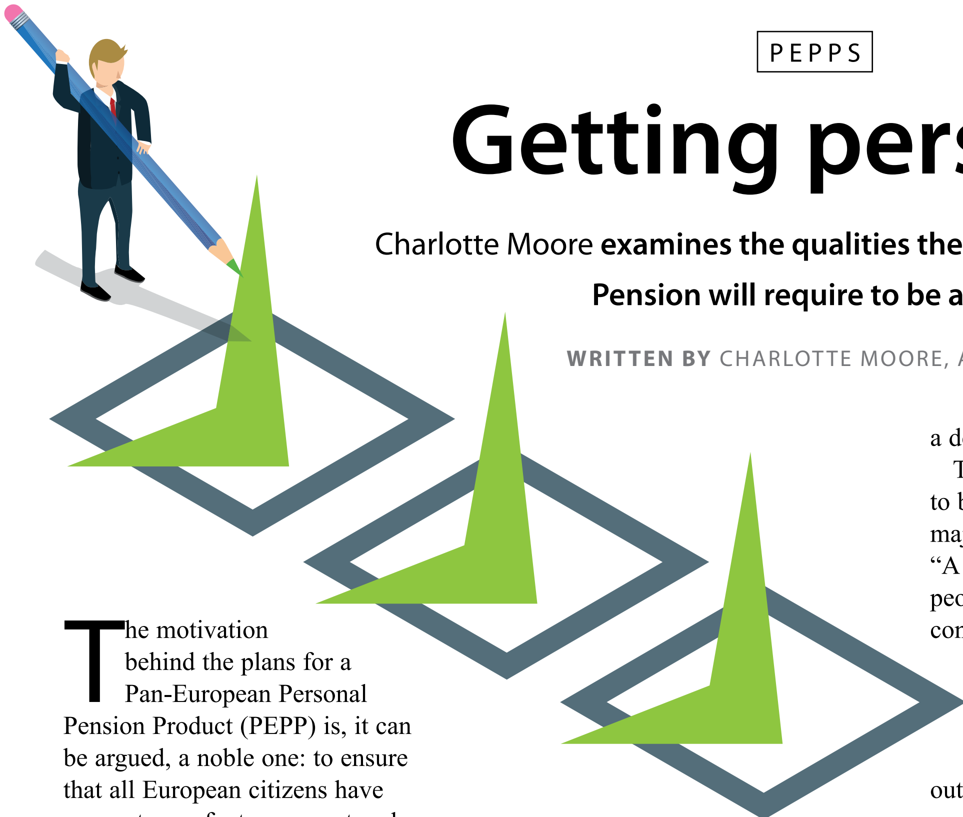

PEPPS

Getting personal

Charlotte Moore examines the qualities the Pan-European Personal Pension will require to be a success

WRITTEN BY CHARLOTTE MOORE, A FREELANCE JOURNALIST

The motivation behind the plans for a Pan-European Personal Pension Product (PEPP) is, it can be argued, a noble one: to ensure that all European citizens have access to a safe, transparent and cost-effective pension.

Demographic changes mean that nations cannot be over-reliant on state pension benefits and a stronger private pension system is required.

The European Insurance and Occupational Pension Authority (EIOPA) has been focusing its attention on a personal pension plan as this, it says, would appeal to a greater proportion of the population than a more traditional occupational plan.

EIOPA's leader of the pensions team, Sandra Hack, explains: "Developments in the labour markets make it more likely that people will be self-employed for at least part of their career and to have many more jobs than older generations."

Personal pension plans are also potentially a better option for those nations in central, eastern and south-eastern Europe that have nascent private pension systems. Hack says: "It makes sense to offer these personal pension plans to complement the creation of occupational pension systems in these countries."

Generating appeal

But it's not enough to just have a product that will be useful for the younger generation and does not require an occupational infrastructure – it also needs to inspire consumer confidence.

To achieve those aims, the PEPP aims to provide a product that is perceived to be safe, transparent and cost effective. These characteristics are particularly important if the PEPP is to appeal to people on lower income.

Hack says: "It's important to develop cost-efficient products to ensure charges are not higher than the returns generated by the product."

EIOPA is recommending various design features to this product to keep the costs down. Hack says: "Cost efficiencies can be achieved by making the most of economies of scale – this can be facilitated by a default investment option."

This default should be designed to be a 'safe' investment for the majority of the savers. Hack says: "A default also works because people find too much choice confusing."

But if a PEPP is to offer one default option, then it's important to design a strategy that will give the best outcome to as many people as possible. Hack says: "That means we have to have a vehicle that is not only focused on accumulation but also on creating significant retirement savings."

Proposed features for the PEPP include standardised limited investment choices – there would be one core default option where the link between accumulation and decumulation would be taken into account.

The European Commission has said that the PEPP should provide some protection, that as the minimum whatever has been paid into the product will be received back at retirement.

But while ensuring the PEPP provides a 'safe' investment choice and has some form of guarantee is appealing to consumers, there is a danger that such design features could impose too many constraints on the providers of these products.

Hack says: "It is important to find a balance between regulation that protects the consumer and ensures the providers are incentivised to work on good outcomes and innovative solutions."

Another issue is that the current economic environment is challenging for designers of investment products. Hack says: "Interest rates have been very low for a long period of time."

But this is an also an opportunity to find innovative solutions and the market should be allowed to develop these strategies.

Hack says: "We know that guarantees are costly but they have a value to the consumer." However, EIOPA does not think the default fund of a PEPP has to have a guarantee. Hack says: "Instead there could be an investment strategy that provides a protection mechanism."

One way to achieve these aims would be to protect consumers from downside risk while allowing them to participate in the upside gains.

Hack says: "We would like to transfer some of the lessons from the occupational pension sector to this product."

Profits

EIOPA has proposed that collective profit sharing products could allow a pooling of investments and smoothing of returns across members of the pool, allowing all members to benefit from average long-term returns of the fund and protecting them from extremely negative outcomes and stressed market conditions.

This could be similar to the mechanism now used by with-profits funds and collective defined contributions schemes.

Aegon pensions director Steven Cameron says: "The proposal does look like it is similar to the sorts of funds introduced in the UK a number of years ago to replace traditional with-profits."

The new generation with-profits funds offered a degree of smoothing of the unit values, protecting customers in periods of significant volatility. But to ensure that consumers have trust in this type of product, transparency is needed. Hack says: "The consumer would need to understand the profit sharing arrangement with other members and also the provider of the PEPP."

Profit-sharing arrangements need to be more closely aligned between different countries. Hack says:

"There is huge variation in the allocation of profits between a UK with-profits fund, a French unit linked contract and a German life insurance contract."

IT'S IMPORTANT TO DEVELOP COST-EFFICIENT PRODUCTS TO ENSURE CHARGES ARE NOT HIGHER THAN THE RETURNS GENERATED

There could, however, be a conflict between the need to provide transparency and the mechanisms used to provide profit smoothing.

Cameron says: "New generation with-profits funds required careful management with detailed procedures to manage smoothing and ensure all customers were treated fairly."

For example, when market values are particularly high, the with-profits funds would hold back some profits which could be allocated to consumers when markets were at a lower level.

To implement this effectively requires complex and careful provisions in place to manage the pricing of the fund to not only keep the promises made to customers.

Willis Towers Watson senior consultant Mark Dowsey says: "The fund will be overseen by an actuary who will decide how much of the return can be allocated to members." This amount will be adjusted every year.

To achieve these aims, the fund provider would publish a unit price, which would often be very different to the actual value of the assets'. "That creates transparency issues for many consumers," says Cameron.

Dowsey says: "While it's possible to communicate clearly with the owners of a PEPP what level of profit they can hope to achieve in a year, there is no transparency over the underlying performance of the assets."

Implementing these types of measures also increases the costs associated with the fund. In the UK, for example, it would be impossible to provide the type of profit-smoothing within the charge cap imposed by the government on auto-enrolment funds.

Profit smoothing is not the only way, however, that large scale PEPP funds could achieve better outcomes for members. These funds could also create some innovation decumulation options.

For example, if the fund is large enough, it could create an internal market for more illiquid assets, like property. That would allow older members to sell these to younger members as they reached retirement. This would achieve a better price for these assets as they would not be affected by the impact of illiquidity on pricing.

Hack says: "There could also be greater flexibility for owners of a PEPP fund – they would not have to transfer all of their assets in bonds to match annuity pricing on retirement." They could, for example, keep part of their pot invested.

Hack says: "There is an opportunity with a PEPP to achieve broad economies of scale that will broaden the investment universe and improve cost efficiencies." ■