

## EFAMA's response to EIOPA's Consultation on the PEPP

### Key messages

#### Fee Cap of 1% on the Basic PEPP

- **All costs should be fully transparent to create an open and competitive market that delivers the best possible outcomes for European savers. The fee cap should be designed in such a way as to facilitate the emergence of this new market, not undermine it.**
  - In EFAMA's view, the proposal to include the cost of advice within the cap is likely to lead to the PEPP being commercially unviable. Evidence on the cost of personal pension products, both in Europe and in some large markets outside of it, confirms that a 1% cap will be too low to accommodate advice. Hence, the 'all-inclusive' approach proposed by EIOPA would undermine the market, rather than encourage competition.
  - While technology may make a significant contribution in the longer term, current experience around Europe suggests that the obligations imposed by Article 34 of the PEPP Regulation for the provision of regulated advice will not be met by current robo-advice offerings and will require face-to-face advice. The PEPP is not a product that could be sold in isolation without wider consideration of the customer's circumstances and needs.
  - If in the end, most potential providers are unable to develop an economically viable business model for the PEPP, the personal pension market will remain largely dominated by existing providers, who may continue to focus on national markets without providing any portability service. The goal of the PEPP to create a level playing field between existing providers and new entrants will not be met. Consequently, savers will not benefit from the expected benefits of the PEPP in terms of product choice, quality of advice and value for money.
  - EIOPA should therefore structure the fee cap in a way which focuses on the cost of manufacturing, administration, distribution and portability, and excludes advice costs, in order to give a chance to the PEPP to take off. Such an approach would prove more attractive to providers whilst ensuring that the requirements of the Regulation in relation to the cap are met. Once the dynamics of the new PEPP market are more clearly established, a review of the fee cap structure could be considered. In the meantime, the advice cost should be fully disclosed to consumers, so that they can make informed decisions. This would be the most efficient approach to allow the needed development of a large and

competitive EU level market for personal pensions and ensure the PEPP delivers best value for money to EU savers.

- **The exclusion of the guarantee from the cap appears to suggest that regulators do not recognise the value that lifecycle strategies can offer savers. This works against the principle of level playing field.**
  - The exclusion of guaranteed products from the cap appears to discriminate against providers of life-cycle strategies whose full costs are included within the cap. It is not clear why a nominal guarantee should benefit from a more favourable regulatory treatment rationale than an investment strategy designed to delivery significant real-term growth over many years.
  - Whatever treatment EIOPA chooses, it is crucial that the cost charged for the capital guarantee be explicitly and separately disclosed in the PEPP KID and calculated according to a robust, clear and transparent methodology set out by EIOPA. Without having a common methodology, NCAs would need to adopt their own criteria to assess the evidence provided by providers; this would lead to different standards at national level, which would erect barriers to the single market for the PEPP.
  
- **While higher charges will reduce returns in a linear way, transaction costs do not work in the same manner and may vary significantly according to asset class invested in and prevailing market conditions. The charge cap definition will serve to unnecessarily complicate the delivery of effective life-cycle strategies.**
  - Transactions costs are not payments to fund managers; they are a necessary part of delivering well-designed life-cycling strategies in the markets and managers' fiduciary obligation to investors when incurring transaction costs on their behalf is comprehensively regulated under the MiFID 2 best-execution rules. While higher charges will reduce returns, there is no correlation between the level of transaction costs and returns generated, particularly in less liquid asset classes. Inclusion in the fee cap would be detrimental to PEPP savers because it unnecessarily complicates the investment process for an apparent benefit that has no clear empirical justification.

### **Risk-Mitigation Techniques**

- **EFAMA fully supports EIOPA's proposal that the PEPP provider should ensure that its investment strategy allows to recoup the capital at the start of the decumulation phase with a certain probability, taking into account the results of stochastic modelling.**
  
- The probability threshold should be set by EIOPA, taking account of the basic assumptions to be used for the necessary stochastic modelling. In view of the low-returns environment in which the world seems to have set in, we strongly recommend the following:
  - For the Basic PEPP, the probability of recouping the capital should be around 95%, unless the remaining accumulation phase is less than ten years when taking up the PEPP and where a probability of around 90% could be used.
  - For the PEPP using alternative (self-select) investment options, the probability should be 90%.

- The PEPP KID should properly inform prospective savers about these probabilities.

### **The PEPP KID**

- **PEPP documentation should be designed both to be digitally delivered and subject to rigorous customer testing to ensure it provides robust but accessible information for a product that will typically be delivered over many decades.**

#### **Summary risk indicator**

- A new methodology needs to be developed to take into account the age of the PEPP saver, and the different types of risks savers are facing – investment, inflation and shortfall in relation to expected outcome.
- A life-cycling strategy consistent with the goals of recouping the capital and outperforming inflation should not be considered as riskier than a guaranteed product showing a low probability of outperforming inflation.

#### • **Past Performance**

- The KID should present past performance for the last 5 or 10 years, where available, to avoid focussing on short-term volatility.
- We have strong reservations about the use of EIOPA's ultimate forward rate (UFR) as a proxy for the long-term risk-free rate. It would be misleading to suggest that savers can expect to obtain the current UFR level (3.75%) without taking any risk, in today's ultra-low interest rate environment.
- More generally, we strongly recommend not to confuse investors with a benchmark. What might be useful is to link the presentation of past performance to the inflation rate since maintaining the purchasing power of accumulated capital should be a minimum goal.

#### • **Performance scenarios**

- We recommend to base performance scenarios on a stochastic basis to provide a whole range of possible outcomes for future pensions, each with their own associated probability. This can provide customers with a better understanding of the range of uncertainty inherent in long term saving.

**Q1. Do you have any comments on the presentation of the information documents? Do you find the preliminary, illustrative examples of the mock-up PEPP KID and PEPP Benefit Statements are translating well the outlined objectives?**

**Q2. Do you agree to approach the areas of risk/ rewards, performance and risk mitigation for the PEPP in a holistic manner?**

**Q3. Do you agree to measure the risk inherent in PEPP as the dispersion of pension outcomes and to link it to objective of reaching at least the long-term risk-free interest rate?**

EFAMA supports the principles adopted by EIOPA for the presentation of the information documents.

- **The RTS should allow for the provision of the PEPP KID and Benefit Statement by digital means in a way that permits the layering of information.** The core requirements (such as summary risk indicator, presentation of cost, past performance and performance scenarios) should be presented in the first layer. All other information can be detailed in subsequent layers.
- **Consumer insight should inform design decisions.** Consumer testing is essential to understand how to engage savers with their pension savings early on so that they get the information they need to determine if the product is providing value for money. A digital version of the PEPP KID should also be tested.
- **Disclosure should reflect the time horizon of the product.** Risk and performance in a pension product have to be calculated and communicated differently than an investment product with a shorter time horizon, in particular to avoid discouraging savers from investing because of short-term volatility in the earlier stages of the investment period. Hence, the methodology developed in the PRIIPs Regulation for the calculation of investment risk cannot be applied to the PEPP because the PEPP is very different in nature from a PRIIP.
- **Risk and reward.** The summary risk indicator and the performance scenarios/pension benefit projections need to be presented next to another, to help savers understand the positive reward for taking risk in financial markets over a long-term horizon.
- **Transparency of cost and information.** It is important that information is presented in a way that is understandable for the consumer. Clarity, simplicity and meaningfulness help investors make informed decisions; hence implementing comprehensive standards on cost transparency will give people the confidence that there are no hidden fees.

We provide below comments on the illustrative examples of PEPP KID.

By way of introduction, we would like to note that it would have been helpful if one of the two illustrative KID examples had been given to illustrate the content of the KID of a Basic PEPP provided on the basis of a risk-mitigation technique (life-cycling).

### ***'What is this product?'***

The KID for the Basic PEPP should clearly inform the saver about the specific nature of the Basic PEPP, particularly the fact that the Basic PEPP can be designed on the basis of a guarantee on the capital, or a risk-mitigation technique consistent with the objective to allow the PEPP saver to recoup the capital at retirement.

From this perspective, we strongly recommend to reword the section 'Guarantee/risk-mitigation technique'.

- There is no need to include 'Basic PEPP' in this section as the top section of the KID should clearly highlight that the product type is the Basic PEPP.
- **The text 'No guarantees' should be replaced by 'risk-mitigation technique' or 'life-cycling strategy'**. The text should explain that the risk-mitigation technique is consistent with the objective to allow the PEPP saver to recoup the capital at retirement.
- The sentence 'inflation is partially covered' is confusing. If the provider offers a nominal guarantee calculated on the basis of amounts investible after deduction of all fees, charges and expenses, as requested by the Regulation, **the KID should explain the exact nature of the guarantee.**
- **The KID should provide a description of the investment strategy** that will be used by the PEPP provider in order to comply with the requirement set in Article 28 (3) (c) (i) of the PEPP Regulation.

### ***'What are the risks and what could I get in return?'***

We support the proposal that the KID provide the value of the lump sum that the saver can expect to obtain under three scenarios.

We also support the idea of informing savers about the monthly payments that they can expect, provided that these payments are calculated on the basis of a transparent and robust methodology developed by EIOPA. We recognize though the difficulty of pricing a representative annuity to be bought 20 or 40 years after the saver started to save in the PEPP. If developing such methodology proves to be too difficult, we strongly suggest to only refer to the lump sums that could be received at retirement, to avoid giving unreliable information to potential savers.

In our view, the value of the lump sum/monthly payments that a saver can expect under the best estimate scenario should correspond to the mean (median) value of assets generated by the stochastic simulations. The

value of the lump sum/monthly payments should correspond to the 10<sup>th</sup> and 90<sup>th</sup> percentiles of the probability distribution under the favorable and unfavorable scenario.

We do not understand why the risk indicator in illustrative example A is related to the question ‘*How likely it is that I will reach my retirement objective?*’ This question is not consistent with the view presented in the Consultation Paper that the ‘*summary risk indicator should link the riskiness of the investment option to the relative deviation of the projected pension projection from the best estimate result.*’ In essence, we do not understand how a generic KID could say something about the likelihood that a given investment strategy permits to reach someone’s retirement objective, as this objective depends on the retirement-related demands and needs of the prospective saver. In addition, the PEEP Regulation requires that the Summary Risk Indicator should be supplemented by ‘*a narrative explanation of that indicator, its main limitations and a narrative explanation of the risks which are materially relevant to the PEPP.*’ In our view, the main risk relates to the probability not to recoup the capital invested at the end of the accumulation phase, after deduction of all fees and charges.

**We have assumed that this information would reflect the outcomes of stochastic projections.** We indeed believe that future projections should be based on a stochastic basis, rather than on a deterministic basis. The problem with deterministic projections is that they yield seemingly accurate estimates of the pension benefit, whilst providing no information as to how likely such an outcome is. In other words, the main drawback of deterministic projections is that they lack probability distributions that permit assessing uncertainty more accurately. On the other hand, stochastic projections provide a whole range of possible outcomes for future pensions, each with their own associated probability. In our view, this approach allows to convey the most valuable information on uncertainty and risks.

The table below, which is based on the table presented in illustrative example A, presents the information that could be provided to prospective savers. In presenting this table, we aim at making suggestions to help EIOPA finalizing its work on the KID, reiterating the importance of undertaking appropriate consumer testing.

The following comments on the content of the table are also important:

- Column 1: the results of the projections should be calculated in relation to the number of years before retirement.
- Column 3: it would be useful to give an indication of the capital invested, in nominal terms before deduction of all fees.
- Column 5: as explained earlier, the monthly payments should be calculated on the basis of a transparent and robust methodology developed by EIOPA.
- Column 7: it is important to provide an estimation of the monthly payments under the three scenarios, assuming EIOPA is able to develop a methodology.

- Column 8: This column should report the Summary Risk Indicator, which should ideally describe the risk as being low, medium or high risk, as proposed on page 15 of the Consultation Paper rather than relying on a risk class from 1 to 7.

☀ Favorable scenario		☁ Best estimate scenario			☔ Unfavorable scenario		
1	2	3	4		6	7	8
Number of years before retirement	Your monthly contribution	Your total aggregate capital contributions at retirement	What can saver expect to receive at retirement?		What can I expect to receive at retirement in a favorable scenario? Lump sum	What can I expect to receive at retirement in an unfavorable scenario? Monthly payments	What is the level of risk?
			Lump sum [best estimate] ☁	Monthly payments [best estimate] ☁			
45	100 €				☀ ☁ ☔	☀ ☁ ☔	
35	100 €				☀ ☁ ☔	☀ ☁ ☔	
25	100 €				☀ ☁ ☔	☀ ☁ ☔	
15	100 €				☀ ☁ ☔	☀ ☁ ☔	
5	100 €				☀ ☁ ☔	☀ ☁ ☔	

☀ There is a 10% probability that you will receive more than the amount shown or a 90% probability that you will receive less.

☁ There is a 50% probability that you will receive more than the amount shown and a 50% probability that you will receive less.

☔ There is a 10% probability that you will receive less than the amount shown or a 90% probability that you will receive less.

In addition to the information provided in the table itself, the KID should provide some explanation. The text we propose is an amended version of the text shown in the two illustrative KID examples:

*'This table shows the money you could get back at retirement under different scenarios and depending on the number of years you are from retirement, assuming a monthly contribution of €100 until retirement.'*

*'The scenarios presented are an estimation of future performance based on evidence from the past on how the value of your retirement assets varies, and are not an exact indicator. What you will get will vary depending on how the market performs and how long you keep the product (i.e. whether you will hold it until you have reached retirement age). The unfavorable scenario shows what you might get back under unfavorable market conditions, i.e. there is a 90% probability that you will receive an amount higher than the amounts shown for these scenarios.'*

Concerning the **summary risk indicator**, we have the following comments. This indicator should be calculated on the basis of a transparent and robust methodology. This methodology should be in line with the following principles:

- The calculation of the risk should take into account the age of the PEPP saver to take into account the length of the investment horizon.
- The risk should be calculated in relation to the value of assets that the PEPP saver can expect to receive at retirement.
- The following risks could potentially influence the quantification of the summary risk indicator:
  - The risk of not recouping the capital invested
  - The risk of not outperforming inflation
  - The risk of not reaching the long-term risk-free rate
  - The risk of not reaching the retirement goal
  - The risk of deviating from the best estimate value of the projected accumulated assets at retirement

Against this background, we strongly believe that the value of the SRI should not depend solely on the *'relative deviation of the projected pension projection from the best estimate result'*, as proposed in the Consultation Paper on page 15. We indeed believe that it would be very misleading to end up with a methodology that would lead to the following incorrect conclusions:

- A PEPP that is consistent with the goals of recouping the capital, outperforming inflation and reaching the long-term risk-free rate with a high probability, can be considered as having a medium or high risk because of the variability of the value of assets at retirement.
- A PEPP that shows a low probability of outperforming inflation and reaching the long-term risk-free rate, can be considered as having a low risk because savers would know what s/he would receive at retirement with a high degree of certainty.

We do not support EIOPA's suggestion to present **past performance** over ten, five, three and one years, because of the long-term nature of the PEPP and the need to avoid focussing on short-term volatility. Instead, we recommend to provide this information for the last 5 or 10 years, or in cases where the PEPP has been provided for less than 10 years, to cover the period for which the PEPP has been provided. On the other hand, we agree that the PEPP Benefit Statement should present the performance achieved during the most recent year because it is a factual account of delivery and, as such, a key measure of accountability of the PEPP provider. However, a comment should remind savers that (i) the PEPP has a long-term investment horizon, (ii) financial markets can be volatile over a short time period, and (iii) the relevant performance should be measured in terms of the level of assets reached at the end of the accumulation phase.

We have strong reservations about the use of **EIOPA's ultimate forward rate** as a proxy for the long-term risk-free rate. The UFR concept is largely unknown to most. More importantly, its name suggests that savers could



expect to obtain this level of performance without taking any risk. It is sufficient to point out that the UFR for the euro applicable in 2020, which was calculated by EIOPA in May 2019, is equal to 3.75%. In today's ultra-low interest rate environment, it would therefore be misleading to suggest that savers can expect to obtain this relatively high level of return without taking any risk.

More generally, we note that the Regulation does not require to compare the PEPP performance with a benchmark. We therefore strongly recommend not to confuse savers with a benchmark. What matters for them is the expected return they can expect to achieve at the end of the accumulation phase.

We recognize however that it might be useful to link the presentation of past performance to the inflation rate.

### ***'What are the costs?'***

We support full transparency of all costs related to the investment management, the guarantee, the transaction costs incurred in delivering returns, and the administration, distribution and provision of advice. We also strongly support the creation of a highly transparent and cost-effective personal pension product. Customers should also be able to benefit from a diverse and competitive market, with scale and persistency of saving helping to drive lower costs over time.

The cost table should include the cost of advice as a separate cost item rather than bundling it with the cost of distribution on the grounds that the customer should be able to see the cost for every element of the value chain.

It is surprising that the illustrative examples do not include a line to show the cost of the guarantee, as the two examples are related to PEPP offering a guarantee on the capital. **The explicit cost of a guarantee must be disclosed in the KID.** This is particularly important if the guarantee is excluded from the cap in order to ensure that savers are well informed when deciding which investment option would best meet their needs.

Concerning the costs of the guarantee, we strongly disagree with the definition proposed on page 20, i.e. *'the premium charged for guarantees, which reflect the market price of the cover against the risk of financial loss, or limiting the financial loss or the cover of biometric and any other risks'*. The KID should clearly separate the costs directly linked to the capital guarantees, from the cost of providing some insurance coverage against biometric risk or other risks. In addition, the costs of guarantee should be calculated according to a well-defined methodology to ensure a level playing field between providers and avoid possible loopholes such as the possibility to include some costs within the guarantee in order to reduce the charge levied under the fee cap.

### ***Other comments***

**Article xa (1) on page 10:** There are two key operating systems iOS and Android for phones and multiple others for PCs. It is quite a technical challenge to develop fully functional sales and dealing transactional functionality for every system and providers will not necessarily know which system their clients use. Hence, we suggest to

soften the wording in the following way: *'Providers should consider the usability and presentational outputs of the PEPP KID on different operating systems.'*

**Article xc on page 11:** Providers should also be required to outline any tax benefits or contribution limits or other restrictions under local labour and tax provisions to ensure investors understand local restrictions and benefits (if any). However, it should be clear that PEPP providers are not supposed to act as tax advisors; it would therefore be useful to inform savers that they should consult tax advisors if they want to receive advice on tax issues.

**Q4. To ensure consistency in the application and comparability of the information on past performance, performance scenarios, pension projections, summary risk indicator and to assess the effectiveness of the applied risk-mitigation techniques - do you agree for EIOPA to set the key assumptions and inputs used for the necessary stochastic modelling?**

In our view, the key assumptions and inputs used for the performance scenarios, pension projections, summary risk indicator and stochastic modelling should be set by an independent body of experts, taking into account comments from practitioners to ensure cost efficiency and business relevance. This is partly about protection for the regulator, which could otherwise find itself in a position of having to justify decisions on areas that may be controversial. Independent oversight helps to resolve this.

**Q5. Do you agree that PEPP's product supervision requires one set of relevant information to carry out the duties of home and host supervisors as well as of EIOPA?**

EFAMA agrees that PEPP's product supervision requires one set of relevant information to carry out the duties of home and host supervisors as well as of EIOPA. This is particularly important because the PEPP Regulation will need to be commonly applied by each Member States, unlike the IORP Directive which could be transposed by including local specificities. EIOPA should play the role of arbitrator between a provider and a NCA in case of difficulties in the application for registration of a PEPP.

**Q6. Do you agree with the 'all inclusive' approach to the Basic PEPP's cost cap? Do you agree that the capital guarantee is a distinct feature, which costs should not be included?**

**1. We agree with an 'all inclusive' approach that would keep the cost of advice outside the cost cap**

We regret that a full impact analysis of the cost of providing advice on the PEPP was not conducted. We are indeed convinced that the obligations imposed by Article 34 of the PEPP Regulation concerning the provision of advice will require PEPP providers and distributors to commit significant financial resources, as they will need to

- a) obtain highly personalized information from savers (including on their accrued retirement entitlements under Pillar 1 state, Pillar 2 occupational and other Pillar 3 pensions entitlements) to specify their retirement-related demands and needs;
- b) provide savers with a personalized recommendation explaining why a particular PEPP would be best for the savers, as well as personalized pension benefit projections;
- c) demonstrate to competent authorities on request that natural persons giving advice on PEPPs possess the necessary knowledge and competence to fulfil their obligations under the Regulation; and
- d) propose a contract, which the savers will need to fully understand before agreeing to sign it.

All of this underlines the fact that the provision of advice on the suitability of the PEPP will involve the assessment of many data points about the individual's specific situation. As most EU member states do not yet have a fully functional pensions dashboard to facilitate this assessment, the process of assessing an individual's needs will be time consuming.

The knowledge, experience and financial situation of a consumer will vary. For a younger customer holding no existing pension products, the suitability assessment should be more straightforward than for older consumers. For the younger savers this will be a matter of establishing the retirement need and checking affordability to assess how much should be contributed keeping in mind s/he may have limited access to this money for many years. However, there may also be an assessment required as to eligibility for the tax benefits and explaining any limitations such as the need to earn a certain level of income for example. This information gathering and assessment process will be quite complex and time consuming. As the mandatory advice to be given is not defined in detail in the PEPP Regulation, providers will also have to deal with different requirements at national level.

For the older consumer who has already been working for a few years and may have existing pillar 2 or pillar 3 pensions arrangements, there is more information to gather and analyse before a suitability assessment and recommendation can be made. In addition to questions around affordability and commitment to a long term contract with access restrictions to the money once held in the PEPP, other questions might arise, for example: should the individual top up his/her existing pension plan arrangements rather than taking out the new PEPP? This will require an assessment of existing pension contract details and arrangements. Often the consumer is unclear what these are and so time is taken to obtain copies of employers' scheme details or existing personal pension contracts.

A number of operational questions are also bound to arise. If advice is provided by the saver's own adviser, how will the PEPP provider communicate regarding the cost of advice to ensure that advice remains below the cap? Assuming that the advisers advise their clients on a number of different issues, how will they be able to separate out the cost of advising on the PEPP from advising on other aspects of an individual's savings decisions?

In determining the scope of the fee cap, the following considerations are also of relevance. Firstly, a thorough analysis of the cost of providing a PEPP should also take into account the obligation to offer national sub-

accounts for at least two Member States, which will result in an additional cost. Secondly, the PEPP will be a new product, which will compete with existing local pension products, which means that much will have to go into marketing the product and how it sits alongside existing personal pension products, other long-term savings and retirement products and how it complements existing national pension savings.

**If in the end, most potential providers are unable to develop an economically viable business model for the PEPP, the personal pension market will remain largely dominated by existing providers, which will most likely continue to offer their existing range of products at national level, without providing any portability service. The goal of the PEPP to create a level playing field between existing providers and new entrants will not be met. The market will remain fragmented and competition will not increase in this market. Consequently, consumers will not benefit from the expected benefits of the PEPP in terms of product choice, quality of advice and value for money.**

Against this background, **EFAMA strongly believes that EIOPA should structure the fee cap in a way which focuses on the cost of manufacturing, administration, distribution and portability, and excludes advice costs. Once the dynamics of the new PEPP market are more clearly established, a review of the fee cap structure could be considered.** In the meantime, the advice cost should be fully disclosed to consumers, so that they can make informed decisions. In our view, this would be the most efficient approach to allow the needed take-off of a large and competitive EU level market for personal pensions and ensure the PEPP delivers best value for money to EU savers.

## **2. Limitations of automated advice**

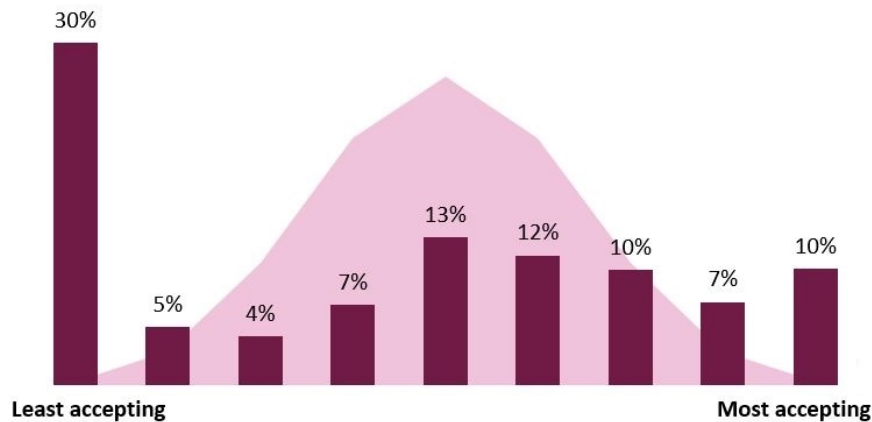
EFAMA welcomes the fact that the PEPP Regulation opens the door to the possibility of providing advice through an automated or semi-automated system. However, we believe that robo-advice is not yet ready to replace traditional advice and that PEPP providers will not be able in the years to come to rely on this happening as a way to limit the cost of the provision of regulated advice.

### ***It will take time before the advice gap could be solved by robo advice***

Prospective savers will need to sign a contract and, in principle, undertake to contribute to a PEPP on a regular basis by consuming less. For voluntary, proactive saving, taking this step requires strong motivation, understanding of the long-term benefits of saving for the future and trust in the providers of savings products. It is well established that European citizens have a weak propensity to save for retirement on a voluntary basis, This is an important reason why face-to-face meetings and calls are key to convincing people to start saving for retirement. You cannot distribute online pension products in the same way as consumer goods because most citizens prefer to postpone their decision or consider pensions savings as a complex issue.

Recent research into consumer attitudes carried out by the Financial Conduct Authority in the UK confirms that robo advice has a way to go before it could be considered as a solution for widespread and affordable financial guidance.<sup>1</sup> In a nutshell, based on a representative sample of 1,800 individuals, the study shows the following:

- A majority of consumers rejected the investment advice offered by a robo adviser.
- Attitudes among some consumers were quite polarized. A hard-core of refusers – some 30% -- appeared to have a strong disposition to reject robo advice. The chart below also shows that only 10% of people tended to accept robo advice in almost all situations.
- Among those who had rejected robo advice, 72% of individuals indicated that they would prefer to receive in person advice.
- Younger consumers are more likely to accept robo advice. However, those who may be the most in need of advice – young people of lower socio-economic status and with low financial literacy – may be least likely to embrace support through robo-advice.



### ***Digital distribution regime encounters difficulties***

Recent industry experience confirms that distributing investment products through robo-advice is not straightforward:

- At the end of November 2019, Allianz Suisse discontinued its digital asset management venture Elvia E-invest. The market does not yet show the expected momentum, the company explained in writing the decision. The Swiss market is not yet ripe for a purely digital offer. Instead, the insurer now wants to sharpen the focus on the 'great potential' in personal provision business. With the end of the Allianz-Suisse Robo, the emerging scene of digital asset managers has one protagonist less. For example,

<sup>1</sup> See article on <https://www.fca.org.uk/insight/robo-advice-%E2%80%93-will-consumers-get-programme>.

robots in Switzerland managed 0.01 percent of the total assets managed in this country, according to an industry study. This study highlighted the fact that the problem is not so much the performance, but the high cost of the offers.

- ABN AMRO Bank closed in March 2019 the digital platform (Prosperity) it had introduced in Germany in 2017 to provide a comprehensive view of the client's current and potential assets, actively manage their investments and offer remote personal coaching at a fixed fee. According to the Bank, *'the absence of a distribution channel has made it difficult to attract clients and the number of clients interested in using Prosperity had not met expectations. Growing the number of clients would involve significant additional investments.'*
- Santander recently folded Sina, its German online investment manager, less than two years after its inception.

In light of this reality, opportunities for growth are increasingly seen as lying within hybrid models where traditional distribution channels are mostly used to recruit new savers and where digital tools can be used in a second phase to optimize their investment allocation/choice.

### ***Robo-Advice may provide simplistic solutions***

Better Finance has recently published its 2019 edition of the Robo advisory business from the perspective of individual investors and savers.<sup>2</sup> In a nutshell, this report shows the following results:

- The algorithms used by the platforms tested in the report do not seem reliable for investment advice.
- The different platforms seem to be operating under quite different perceptions of what information is necessary to present suitable investment advice.
- Different degrees of suitability emerge from the analysis questioning the quality of the investment advice in relation to the investor profile.
- Only a few platforms achieve a high degree of suitability in terms of alignment with the risk profiles.

On the basis on these findings, Better Finance makes the following recommendation:

*'Considering the low quality and suitability of some algorithms assessed in this report and the increasing use of Artificial Intelligence in our society, in particular in the financial sector, we believe that legislators should propose a legislative framework that ensures that Automated-Decision Making (ADM) systems as Robo-advisors are accountable, transparent and fair for EU citizens. The algorithms of Robo-advisors need to be*

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<sup>2</sup> See <file:///U:/Documents/Robo-Advice-Report-2019-FINAL.pdf>.

*developed on criteria that comply with the legislation (MiFID II) with regards to the investment advice process, in order to ensure a harmonised, minimum level of quality.'*

This recommendation confirms that promoting the use of automated system to provide a personalized and suitable advice to prospective PEPP savers would be a dangerous road to take for the time being. The reliability of the robo advisory business to provide suitable investment advice is still too weak. New algorithms will need to be developed to comply with the requirements set in the PEPP Regulation for the provision of advice. This will require time and significant investment in IT. Since financial literacy and trust in financial services amongst EU citizens as savers are low, it will take a lot of convincing to persuade savers to rely on robo advice. The issue will be all the more sensitive as savers will have to give away sensitive personal data in particular on their accrued retirement entitlements.

Article 34.6 of the PEPP Regulation underlines the importance given by the co-legislators to the provision of high-quality advice, by requiring that PEPP providers and PEPP distributors demonstrate that *'natural persons giving advice on PEPPs possess the necessary knowledge and competence to fulfil their obligations under this Regulation.'* In this context, we find it hard to believe that Member States would trust that an automated system could have the *necessary knowledge and competence to fulfil* to comply with the Regulation's obligations.

### **3. Country-based data on the cost of advice**

#### ***Highlights***

The evidence provided below on the cost of personal pension product provision, both in Europe and in some large markets outside of it, confirms that following the 'all-inclusive' approach proposed by EIOPA would undermine the will of most if not all potential PEPP providers to enter the PEPP market because they would not be able to offer profitable products.

- Data from **Italy**, **Australia** and the **UK** show that personal pensions have a higher cost than occupational pensions because they are subject to higher distribution and advice costs.
- Data from the market in **Italy** shows that only three products following an equity-based strategy have a cost below 1%. This number would probably be reduced to lower if transaction costs are taken into account. This confirms that an "all inclusive" fee approach will have a negative impact on the offering of Basic PEPPs based on a life-cycle investment strategy because those strategies require managing a relatively high level of equity exposure, except when the saver is approaching retirement. The data shown below on the costs of life-cycling strategies offered in Australia support this view.
- Recent data from the **UK** confirms that the on-going cost of advice is higher than 0.60%, which comes in addition to an initial charge close to 3%. Evidence from **Germany**, **France** and **Austria** confirms that providing in person advice costs at least 0.50%. Quantified in monetary terms, a client meeting costs at least €135 (+ VAT).

- Data from **Australia** confirms that the costs of life-cycle strategies offered to savers by very large not-for-profit workplace superannuation funds are close to 1%, excluding the cost of advice. The data also confirms that the total cost of small pension accounts excluding the cost of advice is significantly above 1%.
- A study from Strategic Insight showed that the average fee paid by investors to get some professional advice in the United States ranged from up to 1.5% for small investment accounts (below \$100,000), down to approximately 1.0% for investments around \$1 million and less for multi-million dollar accounts.<sup>3</sup> The current cost of regulated advice suggests that this alone could account for 50-100% of the total fee cap in some jurisdictions.

### **Country-based evidence – Italy**

Figure 1 below aims at giving an overview of the cost for pension products in Italy, on the basis of available information available on the COVIP website. The Synthetic Cost Indicator (SCI), the figure taken as reference in the table below, is expressed in percentage terms of accumulated capital and includes all kinds of costs, including the cost of the guarantee (where the guarantee is provided), but excludes transaction costs and performance fees.

There are two kinds of personal pension products (PPPs) in the Italian market:

- **Open pension funds** (so-called '*Fondi pensione aperti*') - they are UCITS-like pension plans open both to individual and to occupational members. The open pension funds are offered by different kinds of financial companies (asset management companies, banks, insurance undertakings) and are officially classified as IORPs.
- **Insurance-based personal pensions ("PIP")** - they are open only to individual membership and can be offered only by insurance undertakings.

Both types of PPPs usually have three to five investment options, including a guaranteed option.

Figure 1 shows that very few PPPs are being offered in the Italian market within a 1% cost threshold. Basically, those products are open pension funds following a fixed income investment strategy or offering a guarantee. Only three products offering an equity based strategy are below the 1% cap.

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<sup>3</sup> See Strategic Insight (2017): "Monitoring Trends in Mutual Fund Cost of Ownership and Expense Ratios: a Canada – U.S. Perspective 2017 Update".



**Figure 1**

**Open Pension Funds and PIPs - Synthetic Cost Indicator (10 years)**

(end-2018 data or more recent data available; assets in thousands of euros, SCI in per cent value)



This finding confirms EFAMA's view that including the costs of advice in the 1% fee cap would reduce very much the possibility of offering life-cycle investment strategies because those strategies involve maintaining a high level of exposure to equity and less liquid assets in the early phase of the accumulation phase. Practitioners have the responsibility to alert EIOPA to the risk of ending up in a situation where no PEPP will be offered in the years. This would be all the more regrettable given that the European investment management industry has long supported the idea of creating a pan-European personal pension product.

Table 1 below confirms that a substantial part of the costs is used to remunerate the costs of distribution and advice. These costs can be estimated by calculating the difference between the Synthetic Cost Indicator of PPPs (Open Pension Funds and PIPs) and Contractual Pension Funds (*Fondi pensione negoziali*), which are the most important kind of occupational pension funds existing in Italy. Typically, these funds are established at industry level and dedicated to workers for which the relevant national labor contract applies. These funds are run as non-profit institutions and are offered directly to workers. As a consequence, they do not have to pay for the distribution and advice services offered to citizens saving in a PPP. This is the main reason why the cost of contractual pension funds shows in Table 1 is considerably lower than the cost of open pension funds and PIPs.

**Table 1**

**Pension Funds and PIPs - Synthetic Cost Indicator by type of investment sub-fund**  
*(end-2018 data or more recent data available; percentage composition)*

<b>Type of investment sub-fund</b>		<b>10 years</b>		
		<i>Average</i>	<i>Minimum</i>	<i>Maximum</i>
Guaranteed sub-funds	Contractual Pension Funds	<b>0.47</b>	<i>0.31</i>	<i>0.87</i>
	Open Pension Funds	<b>1.21</b>	<i>0.60</i>	<i>2.22</i>
	PIPs	<b>1.87</b>	<i>1.20</i>	<i>2.58</i>
Bond sub-funds	Contractual Pension Funds	<b>0.36</b>	<i>0.16</i>	<i>0.81</i>
	Open Pension Funds	<b>1.10</b>	<i>0.55</i>	<i>1.71</i>
	PIPs	<b>1.95</b>	<i>0.58</i>	<i>2.81</i>
Balanced sub-funds	Contractual Pension Funds	<b>0.35</b>	<i>0.18</i>	<i>0.81</i>
	Open Pension Funds	<b>1.44</b>	<i>0.78</i>	<i>1.88</i>
	PIPs	<b>2.24</b>	<i>1.56</i>	<i>3.11</i>
Equity sub-funds	Contractual Pension Funds	<b>0.39</b>	<i>0.22</i>	<i>0.81</i>
	Open Pension Funds	<b>1.69</b>	<i>0.75</i>	<i>2.58</i>
	PIPs	<b>2.72</b>	<i>1.04</i>	<i>4.07</i>

**Country-based evidence – United Kingdom**

The UK’s experience with fee caps should not be regarded as a valid basis for proposing a 1% all-inclusive fee cap.

- **Workplace pensions:** the default investment strategies in occupational pensions are subject to a 0.75% fee cap since April 2015. However, an occupational plan based on auto-enrolment with no advice requirement has a very different cost structure from a third pillar pension product such as the PEPP, which is subject to different distribution costs and mandatory personalized advice. Hence, the ability of UK providers to supply workplace pension products within the 75bps cap is not a justification to apply a cap to a third pillar product in the more fragmented European market, where the cost of customer acquisition is likely to be quite high. Overall, the UK experience on the 75bp charge cap shows that while costs have gone down, **the impact on investment has led to lower levels of diversification and a desire to minimise investment costs, regardless of the possible impacts on members’ outcomes.**
- **Stakeholder pensions:** Stakeholder pensions were introduced in 2001 as a way to encourage more voluntary pension saving, with charges capped at 1.5% for the first ten years and then at 1% thereafter. Once again, and in stark contrast to what is proposed for the PEPP, **stakeholder pensions can be sold without advice, which is a crucial difference.**

The Financial Advice Market Review (FAMR) was launched jointly by the FCA and HM Treasury in August 2015 with the aim of identifying ways to make the UK’s financial advice market work better for consumers. In 2017 FAMR undertook a review of its original report. The FAMR Baseline scenario from June 2017 includes a review of the cost of advice and fees charged by advisors in terms of ongoing and initial advice provided. The survey

looks at restricted advice (defined as personal recommendation to a retail client in relation to a retail investment product which is not independent advice or basic advice) and independent advice (based on fair and comprehensive analysis of those products that are capable of meeting the clients stated investment objectives and needs). **Overall, percentage charges were on average just over 3% for initial advice and almost 0.7% for ongoing services.** Restricted advisers recorded slightly higher initial charges but slightly lower ongoing charges than independent advisers over the period.<sup>4</sup>

Fee type	Restricted advice	Independent advice	All advisers
Initial	3.57%	2.81%	3.12%
Ongoing	0.63%	0.72%	0.69%

Source: Financial Advice Market Review – Baseline Report (June 2017)

In addition, as shown in the table below, the cost of the advice changes on the basis of the amount invested (which is not the case for the PEPP where the fee cap is set at 1% independently from the assets under management). The costs of providing advice include the costs of marketing expenditure, staff costs, insurance costs and regulatory costs and fees. Based on the average net salary of European citizens, they will contribute small amounts to the PEPP.

Amount	Initial charge	Ongoing charge	Percentage of sample	Average amount	Illustrative initial charge
Less than £50,000	3.4%	0.71%	70%	18,500	£629
£50,000>£99,999	3%	0.68%	16%	69,000	£2,070
£100,000>£149,999	2.2%	0.64%	6%	115,000	£2,530
£150,000>£199,999	1.5%	0.76%	2%	173,000	£2,595
£200,000+	2.1%	0.66%	5%	401,500	£8,431.50

Source: Source: Financial Advice Market Review – Baseline Report (June 2017)

### **Country-based evidence – Germany**

According to our German member association, the cost of distribution/advice in retail funds would be around 0.4 basis points. In the German model, it is not possible to clearly separate the cost of distribution and advice from the management fee. In addition, a client meeting for advice lasts on average 1h30 for a “Riester Rente”, the current German individual pension product (partial process based on MIFID requirements), for **a cost of around 135€**

<sup>4</sup> According to one of our UK based members, the hourly fee for advice is £120 plus VAT per hour.

### ***Country-based evidence – Austria***

According to our Austrian member association, **the cost of advice is around 0.5%**. On the basis of the annual market study of the Austrian Financial market authority for the year 2018 the median ongoing charges figure for Austrian retail funds is 0.68% (bond funds) to 1.73% (equity funds). Those figures do not include transaction costs and advice costs but include distribution costs.

It is also worth noting that the cost for the guarantee in guaranteed pension funds has to be disclosed in the prospectus and the KIID of the funds.

### ***Country-based evidence – France***

Our French member association made a simulation to calculate the total fee that a PEPP provider would collect from a worker saving 5% of a net salary of €25,000, assuming a fee cap of 1%. This illustration is representative of how the PEPP will develop, at least initially, because small amounts will be saved in the PEPP, notably because the tax incentives are likely to be modest.

The results are shown in the table below. In a nutshell, the fee collected in the first year would be €12.3 and the total fee that would be collected after five years could be €200. This is the total amount that the PEPP provider, distributor and adviser would have to share for their services, without knowing if the saver would keep saving in the same PEPP, as the saver may decide to switch to another provider after 5 years. Clearly, these are very small amounts which do not allow to develop economically viable business model for the PEPP.

According to internal estimation, **the cost of advice in France can be estimated to be at least €135/€150 (+ VAT)<sup>5</sup>**, which means that the PEPP provider would be left with maximum €50-€65 to cover all other costs (manufacturing, administration, distribution and portability costs) over 5 years, i.e. less than €1 per month. Offering the PEPP under these circumstances would not be economically viable.

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<sup>5</sup> This amount covers the cost of one or two meetings to gather information of existing pension plans held by the saver, assess the suitability of different investment options in light of the saver's demand and needs, and make a recommendation.

	Year 1	Year 2	Year 3	Year 4	Year 5	TOTAL
<b>Average Salary in European Union 2018 (net of tax/month)</b>						
Germany	2 270					
France	2 225					
Netherlands	2 155					
United Kingdom	1 990					
Belgium	1 920					
Italy	1 758					
Moyenne	2 053					
Annual salary		24 636	25 129	25 631	26 144	26 667
Inflation (ECB max target)	2%					
Annual contributions	5%	1 232	1 256	1 282	1 307	1 333
Expected average yield	4%					
Savings		1 232	2 538	3 921	5 385	6 933
Fees	1%	12,32	25,38	39,21	53,85	69,33
						<b>20 008</b>
						<b>200</b>

### Country-based evidence – Australia





Looking outside Europe, the Australian market of Superannuations provides some useful indication of fee structures for pension funds and the cost of life-cycle strategies. We provide the examples of 'QSuper', a profit-for-member superannuation fund and one of Australia's oldest and largest funds, and 'Rest', a very large superannuation fund offered to retail employees.

The total costs of the four different life-cycle funds offered by QSuper, excluding the cost of advice, are shown in the table below. The cost of the fund falls with the age of the saver, as the share of equity decreases as the saver is approaching retirement. **For savers under 40, the cost for savers is 0.93%.**

The total cost of the core strategy offered by Rest is 0.90% for accounts of \$50,000, and 3% for accounts of less than \$6,000. **This cost does not cover advice.**

#### QSuper fees breakdown

The cost of managing your account is split into administration fees, investment fees, and indirect costs. We calculate and take the fees out before we declare the unit price, every working day.

Investment option	Administration fee p.a. <sup>1</sup>	Investment base fee p.a. <sup>1</sup>	Investment performance-based fee p.a. <sup>1</sup>	Indirect cost ratio p.a. <sup>1</sup>	Total fee p.a. <sup>1</sup>
 Lifetime Outlook (age under 40)	0.16%	0.33%	0.33%	0.11%	0.93%
 Lifetime Aspire (age 40 to 49)	0.16%	0.27%	0.26%	0.10%	0.79%
 Lifetime Focus (age 50 to 57)	0.16%	0.23%	0.22%	0.07%	0.68%
 Lifetime Sustain (age 58 and over)	0.16%	0.17%	0.13%	0.04%	0.50%

Source: <https://qsuper.qld.gov.au/our-products/our-fees/fee-details>

### How your fees might look

If you're in the Core Strategy (and you'd be in pretty good company as most of our members are in this investment option), and have a balance of \$50,000, your annual fees will look like this.

And if your account balance is less than \$6,000, the amount of administration fees, investment fees and indirect costs that you'll pay each year is capped at 3% of your account balance.

Investment fee	0.60% of your balance per annum	\$300
Plus administration fee	\$1.30 per week, plus 0.1% of your account balance at the end of each month (capped at \$800 per annum)	\$67.60 plus \$50 per annum
Plus indirect cost ratio	0.07% per annum	\$35
Total*		\$452.60 per annum

\* If your account balance is less than \$6,000 at the end of financial year, or if you leave Rest, the total combined amount of administration fees, investment fees and indirect costs charged to you is capped at 3% of your account balance for the year (or the period until you left ).

Source: <https://www.rest.com.au/member/products/fees-and-charges>

### Country-based evidence – United States

A study from Strategic Insight showed that the average fee paid by investors to get some professional advice in the United States ranged from up to 1.5% for small investment accounts (below \$100,000), down to approximately 1.0% for investments around \$1 million and less for multi-million dollar accounts.<sup>6</sup>

#### 4. Treatment of transaction costs

A 1% (or any level of) fee within the cap is paid out of the accumulated capital to the provider (and distributor or adviser). All things being equal, this will reduce the return by 1% over the relevant period. **Transaction costs work in an entirely different way.** These costs relate to the payment of a broker on the purchases or sales of securities and the payment of taxes and levies to Governments and/or regulatory bodies or exchanges. The brokerage fees are paid to invest contributions received or meet withdrawals and to achieve positive performance.

**The inclusion of transaction costs in the fee cap would limit the number of portfolio's transactions, with the consequent risk of resulting in missed opportunities to make gains or limit losses. This would be detrimental to PEPP savers.** It would also seriously limit the possibility of running a life-cycling strategy with a sophisticated risk management process investing across different asset classes and financial instruments.

We would like to stress that there are a number of operational challenges in including transaction costs in the PEPP fee cap.

<sup>6</sup> See Strategic Insight (2017): "Monitoring Trends in Mutual Fund Cost of Ownership and Expense Ratios: a Canada – U.S. Perspective 2017 Update".

- **Little room for responsiveness:** It is currently unclear how firms will operationalise a charge cap that included transaction costs. Indeed, within a 100bp cap and assuming the full cost was 100bps, based on existing fund model, firms would need to make an allowance for transaction costs. If transaction costs were estimated at 10bps, then the PEPP charge could not exceed 90bps. This brings significant challenges regarding margin of error and room for manoeuvre, especially in the event of a major market adjustment or strategy change. Indeed, if the effect of additional trading is to push asset managers beyond their trading budget for the PEPP, then **asset managers would face a perverse incentive not to trade (to avoid making such losses) even though trading may be to the benefit of PEPP savers.** Ultimately such a cost structure could create irreconcilable conflicts between the asset managers' respective duties of care to PEPP savers and their shareholders. PEPP savers would not be well served by such a restriction on how the investment process operates.
- **Total cashflow vs discretionary trading activity:** An immediate practical issue here would be whether the cap is applied to transaction costs at total cashflow level (i.e. including the costs of investing new contributions) or only covers discretionary trading activity that is undertaken to achieve positive performance.

To avoid the costs of simply investing the PEPP saver's on-going contributions using up a significant portion of the cap, it would be necessary to develop a methodology which attempted to cap only discretionary trading activity.

- **Consistent quantification of transaction costs.** It is extremely unclear how to cap implicit transaction costs reflecting the difference between buying and selling prices, not all of which are measurable with any high degree of certainty. Our understanding is that EIOPA proposes to address this problem by defining portfolio transaction costs as *'actual payments by the PEPP provider to third parties to meet cost incurred in connection with the acquisition or disposal of any asset in the PEPP account'*. This is a pragmatic response, which does address the challenges of implicit costs. However, EIOPA should also be aware that this could make equity-based strategies, necessarily for long-term real returns, look much more expensive than investing in bonds or asset classes without explicit brokerage payments or transaction taxes. Again, this illustrates the arbitrary nature of capping transaction costs necessary to deliver an investment return, which could far exceed the costs necessary to enter the market.

## 5. Treatment of the cost of a guarantee

EFAMA considers that the exclusion of the cost of guarantees from the fee cap would distort the level playing field between PEPP providers, for the following reasons:

- The providers of a Basic PEPP using life-cycling will be constrained in designing investment strategies given that all the costs related to the use of these risk-mitigation techniques will be included in the fee cap.

- There is no consensus among experts on how to define price and implement long-term guarantees correctly. This would create an incentive for providers offering a capital guarantee to shift a portion of the other costs to the cost of the guarantee.

EIOPA seems to understand that agreeing on a common methodology for pricing guarantees would be difficult. This is most likely the reason why EIOPA proposed on page 29 of the Consultation Paper that the PEPP provider should *'provide evidence that these costs are directly linked to the capital guarantee upon request by the national competent authority or EIOPA'*. Following this approach would mean that the national competent authorities would have to adopt their own methodology to assess the evidence provided by providers; this would lead to different standards at national level, which would erect artificial barriers to the single market for the PEPP.

In our view, **there are only two ways to prevent this risk: either EIOPA ensures that the cost of guarantees is calculated according to a harmonized, robust, clear and transparent methodology, or EIOPA proposes to include this cost within the fee cap.** We understand that EIOPA fears that this second approach would unduly limit the feasibility and profitability of Basic PEPPs based on a capital guarantee. We draw again the parallel with the cost of advice, whose inclusion within the cap would also limit the feasibility of the Basic PEPP. The same logic should therefore apply in relation to the cost of advice, which EIOPA should exclude from the fee cap.

There is another compelling argument to follow this approach: **nominal guaranteed products are unsuitable for the vast majority long-term investors as they do not protect against inflation.** From this perspective, we do not agree with EIOPA's view that the cost of guarantees should be separated *'to acknowledge the fact that the guarantee adds to the product and provides an additional value for the PEPP saver'*. The rationale for that appears to be that life-cycling, aimed at offering significant real returns, is somewhat an inferior – and less costly – offering to a capital guarantee. Giving this message to consumers would be completely misleading. To put this into context, an annual contribution of 1,000 euros over twenty years (20,000 euros) is worth just 16,300 euros in real terms at the end of the period, assuming inflation at 2% per annum, in line with the ECB inflation target; this represents a drop in purchasing power of nearly 19%.

Professor John Y. Campbell from Harvard University, who is a leading researcher in household finance, summarized very well why holding too much of savings in low-risk and low-return asset portfolios is not a particularly valuable strategy:<sup>7</sup>

- *'First, the positive reward for taking risk in financial markets implies that retirement savings vehicles should not be entirely risk-free. No matter how risk-averse a person is, he or she should be willing to take at least a modest amount of risk to earn a higher return. Quantitatively, the reward for risk is large enough, and most households have sufficiently stable labor income, that allocations to risky assets should be substantial for all but ultra-conservative households.'*

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<sup>7</sup> See Campbell's foreword in Berardi, Tebaldi and Trojani's paper on available on [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3142243](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3142243).



- *Second, an investment strategy of rolling over short-term safe assets is not risk-free over the long run because real interest rates vary over time. Retirees who followed this strategy over the past 20 years have suffered a severe loss of purchasing power as real interest rates have declined. A safe retirement income, of the sort provided by a defined-benefit pension plan, requires an investment strategy based on long-term inflation-indexed bonds. Long-term real assets such as equities and real estate, while not risk-free at any horizon, also generate relatively stable streams of real income over the long run.*
- *Third, the preservation of nominal value is not an appropriate measure of safety because the inflation rate is uncertain. Inflation risk cumulates over time and becomes relatively more important at long horizons. This implies that long-term nominal bonds should be used with caution in a retirement portfolio because they are exposed to inflation risk; and portfolio guarantees stated in nominal terms are ineffective at controlling long-term risk exposure’.*

**Q7. Which criteria should be added to foster the application and development of superior risk-mitigation techniques? Which research and learnings should EIOPA consider in its further work?**

### **1. Life-cycling as a Risk-Mitigation Technique**

A life-cycle strategy is a type of investment strategy which typically gives an important role to equity and other growth assets in the early stage of the accumulation phase to achieve long-term capital growth. It switches to a more conservative approach as the saver approaches retirement to consolidate the capital growth already achieved and to minimise the risks of market volatility reducing the accumulated savings. Research has shown that this switching mechanism is a very effective risk-mitigant tool over a saver’s lifetime that can deliver good outcomes<sup>8</sup>, both consistent with and exceeding the underlying PEPP goal of allowing savers a mechanism to at least recoup their capital.

The capacity of life-cycling to deliver good outcomes relies on three main elements.

- **Taking investment risk is usually rewarded in the long term**

This widely accepted observation justifies investing a significant proportion of the pension savings of younger savers in riskier assets to deliver the growth they will need to provide an income in retirement. Even if market volatility were to result in investment losses in a particular year, the long period of time during which assets are accumulated by young people implies that the probability of a poor outcome is limited. As older people tend to have a shorter investment horizon, life-cycle strategies switch out of higher risk assets in order to protect the accumulated savings against market downturns. As we note earlier, life-cycle strategies can only deliver optimally without artificial behavioural dis-incentives from investing in risk assets: e.g. restrictions on transaction costs.

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<sup>8</sup> See in particular the [Bocconi study](#).

- **Young investors have a greater capacity for investment risk**

Younger investors generally have more time to recover from negative market outcomes than those nearer retirement, thanks to three critical factors: firstly, the return that investing in riskier assets such as stocks provide is higher on average than the risk-free rate over a long investment horizon. Secondly, people tend to have small amounts of assets accumulated for retirement during the first years of accumulation. And thirdly, the de-risking mechanism reduces the exposure to market volatility in the period before retirement when households have a greater capacity to save.

- **Targeting an asset allocation is a key tool for managing investment risk**

The portfolio rebalancing which is performed on a regular basis to maintain the overall asset allocation with the strategy allows to avoid an undue increase in the exposure to risky assets after a strong rebound in markets and to miss the opportunity to invest in riskier assets at lower prices after a market downturn.

The question arises as to whether some risk-mitigation techniques in addition to the switching mechanism should be applied to life-cycling strategies. EIOPA has analysed this question, and came to the following conclusions:

- Setting out strict criteria on investment allocation would *'require perfect knowledge of the ideal investment allocation and would need to take into account the effectiveness of the financial and capital markets in the EEA member states. Further this approach would leave little room for innovation and healthy competition to reach better pension outcomes for consumers – and would render the prudent person principle of the PEPP Regulation unnecessary'*.
- The regulation of the risk-mitigation techniques should *'set out high-level principles on the objective of the different risk-mitigation techniques and adding some general criteria for the main types of risk-mitigation techniques'*.

EFAMA fully supports EIOPA's reservations against regulatory restrictions on asset allocation, whether expressed in quantitative terms (e.g. maximum equity exposure / minimum investment in low risk assets at given moment of the life-cycle strategy) or in limiting access to specific asset classes:

- This approach would require setting asset allocation restrictions that would be difficult to determine with the assurance that these restrictions are not too severe or flexible enough. This approach would also require defining in the regulation of the RMT a taxonomy of assets according to their level of risks. It would be challenging to establish an exhaustive taxonomy and to substantiate the degree of risk of category of assets.

- The real impact of the restrictions will change over time with financial innovation and market conditions to the point they could quickly become ineffective or even counter-productive in relation to their objectives.
- The investment governance process used by fund managers provides an additional, strong and demonstrable protection. A summary description of the safeguards offered by fund managers is provided in section 3 below.

This being said, EFAMA agrees with EIOPA that there may be a role for some general enforceable and quantifiable criteria to ensure that PEPP providers can demonstrate to customers and regulators that their investment process is consistent with the risk profile of the corresponding investment option. In this context, EFAMA fully supports the approach proposed by EIOPA whereby the PEPP provider who do not offer a capital guarantee, would ensure that the saver would recoup the capital at the start of the decumulation phase with a certain probability. The calculation of this probability should be based on the use of a stochastic model to simulate a distribution of investment returns.

A recent report prepared by the OECD team on private pensions, entitled '*An illustration to assess the risk profile of investment strategies*', presents the stochastic methodology that could be used to assess the risk profile of any long-term investment strategy for retirement and calculate the probability for an individual saving for retirement to get back the accumulated nominal value of his/her contributions.

Following this approach would have a number of important advantages:

- **Investment time horizon:** It would ensure that the calculation of the risk of a pension product such as the PEPP is not only based on the risk-return characteristics of the investment portfolio but also take into account the distance to retirement of individuals and the life-cycle approach to investment.
- **Information to savers:** It would also strike a balance between risk and reward by avoiding focusing on short-term risk. In this way, the regulation of the risk-mitigation techniques could avoid falling in the trap to overly allocate to low risk assets which fail to deliver the outcomes expected in retirement.
- **Performance scenarios:** This approach could also be used to prepare the performance scenarios and estimate the range of possible future returns. The use of the proposed approach would also allow to comply with important requirement concerning the PEPP KID.

In our view, this approach should also be used to measure the level of risk of Basic PEPPs designed on the basis of a guarantee on the capital.

## 2. Specific comments

### ***Probability values***

We support the following proposals:

- The probability of recouping the capital should be higher for the Basic PEPP than for alternative investment strategies.
- For the Basic PEPP, we agree that the probability should be reduced if the remaining accumulation phase is less than 10 years when taking up the PEPP in order to take into account the impact of the shorter investment period on the market risk. If the same probability were to be offered to savers of all ages, the provider of the life-cycle strategy would have very limited possibilities to invest in equity and other long-term assets, thereby preventing young savers to benefit from superior returns with very low risk. To avoid confusing savers, the PEPP KID should provide clear indication about the two probabilities levels associated with the Basic PEPP using a risk-mitigation technique. In addition, the PEPP provider or PEPP distributor should provide the necessary explanation when giving advice to the prospective saver.
- In case of adverse economic developments within three years before the expected end of the remaining duration of the accumulation phase, the PEPP provider shall extend the last phase of the life-cycle or the applied risk-mitigation technique by an appropriate, additional time of up to five years after the initially expected end of the accumulation phase, subject to the saver's explicit consent and assuming that this may be legally permitted. Indeed, this provision is founded on the observation that a stock's price will tend to move to the average price over time. Hence, deviations from the average price are expected to revert to the average. Therefore, it makes sense to remain invested following an adverse market fall in order to benefit from the expected rebound of prices; it also ensures that any losses suffered in such a fall are not 'locked in'.

Concerning the proposed level of the probabilities, we have the following comments:

- The OECD study entitled '*An illustration to assess the risk profile of investment strategies*' has shown that it is possible to design life-cycle strategies consistent with a probability of 99% of recouping the capital when the accumulation period is longer than 10 years. For a shorter accumulation phase, the probabilities tend to be lower under the strategies analysed by the OECD.
- The OECD study also assessed the influence of the macro-economic conditions on the probability of getting contributions back, and showed that the probabilities of recouping the capital are significantly lower when the historical returns are based on relatively recent data, i.e. data for the 1999-2018 period, compared to data for the 1969-2018 period. The result is due to the fact that the 1999-2018 period can be characterized as a "low returns" period. When the projections are based on this period, the probability

of recouping the capital under the life-cycle glide path considered by the OECD, is closer to 95% after 40 years, 90% after 20 years and 85% after 10 years.

- **These observations confirm that the probabilities could not be set in the Regulation independently of the applicable basic return assumptions, which will need to be determined by EIOPA.** Against this background, in view of the low-returns environment in which the world seems to have set in, we strongly recommend the following:
  - For the Basic PEPP, the probability of recouping the capital should be around 95%, unless the remaining accumulation phase is less than ten years when taking up the PEPP and where a probability of around 90% could be used.
  - For the PEPP using alternative (self-select) investment options, the probability should be 90%.
  - The PEPP KID should properly inform prospective savers about these probabilities.
- As long as savers are properly informed, we see no problem in that these probabilities are less than 99% or 95%. Besides, the PEEP Regulation distinguishes between two types of Basic PEPP: one with a capital guarantee (associated with a probability close to 100%) or another one based on risk mitigation techniques, which provides savers with a real alternative to the guaranteed PEPP, offering superior returns in exchange for a slightly higher level of risk.

#### ***Objective to be achieved at the end of the accumulation phase***

We fully agree that PEPP providers should design the asset allocation and the de-risking strategy in a way that is 'consistent with the objective to allow the PEPP saver to recoup the capital at the start of the decumulation period. From this perspective, we strongly believe that *Article xa* on page 33 of the Consultation Paper should be corrected in the following way:

*For the Basic PEPP, when the PEPP provider does not offer a capital guarantee, the PEPP provider shall employ an investment strategy that ensures, taking into consideration the results of stochastic modelling, recouping the capital at the start of the decumulation phase ~~and during the accumulation phase~~ with a probability of ~~XX~~99%, unless the remaining accumulation phase is less than ten years when taking up the PEPP and where a probability of ~~YY~~95% may be used.<sup>9</sup>*

It would not make sense to request that the probability of recouping the capital should apply throughout the accumulation phase because this would be tantamount to demanding that PEPP providers permanently invest in short-term fixed-income securities. This would eliminate the rationale of allowing the use of life-cycling as a risk-mitigation technique. Indeed, a life-cycle strategy typically gives an important role to equity and other growth

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<sup>9</sup> As explained above, the final levels of probabilities will depend on the underlying assumptions that providers will have to use in their stochastic simulations.

assets in the early stage of the accumulation phase to achieve capital growth. It is only when the saver approaches retirement that such strategy switches to a more conservative approach to consolidate the capital growth already achieved and to minimise the risks of market volatility reducing the accumulated savings. If PEPP providers have to ensure a high probability of recouping the capital during the accumulation phase, they would have to follow an overly-cautious investment strategy, resulting in a sub-optimal outcome for PEPP savers.

### ***Asset allocation close to the end of the accumulation phase***

In Article *xb* (3), we note the requirement to invest '*predominately*' in liquid, fixed income investments. While this may be appropriate for a retirement pathway into an annuity or capital withdrawal, it may be justified to maintain an equity exposure of around 30-40% for an income drawdown plan in order to be able to deliver the stable income required in retirement.

It is also the same that some illiquid asset may be well suited to the retirement phase if they generate stable inflation-linked cash flows.

More generally, PEPP providers should be allowed to design the asset allocation and the de-risking strategy as they see fit as long as the risk level of the investment strategy is consistent with the objective of allowing the saver to recoup capital at the level of certainty that will be set in the regulation of risk-mitigation techniques.

As the use of the word '*predominantly*' could easily be taken to mean at least an 80% allocation, we strongly to rephrase the third paragraph of *Article xb* in the following way:

*'For the PEPP savers closest to the expected end of the accumulation phase, the PEPP provider shall ensure that the investments are sufficiently ~~predominantly~~ liquid, of high quality and exhibit fixed investment returns to allow that savers can recoup the capital at the start of the decumulation period with the ~~agreed~~ applicable probability, taking into account the choice of the out-payments made by the PEPP savers.'*

### ***Establishing reserves***

We are concerned that Article *xc* allows too much leeway for those providers who use the reserving product types to manipulate performance returns in early years to secure business and competitive advantage. We would recommend the following wording is added to this article at the end of paragraph 5: '*The PEPP provider shall ensure that the terms and conditions as well as the pattern of dis-investment are presented in a transparent and comprehensible manner **and that providers are able to demonstrate that the product is not designed in any way to boost performance beyond the realistic underlying asset projected returns during the early years of the plan.***'

### 3. The safeguards offered by fund managers

EFAMA would like to draw EIOPA's attention to the investment governance process used by fund managers, which will provide an additional, strong and demonstrable barrier protection to PEPP savers.

- **Fiduciary duties**

Fund managers are bound by regulation<sup>10</sup> to act as “stewards” of their investors’ assets, hence to act in the best interest of their clients and to invest in accordance with a predefined set of rules and principles. In this capacity, they owe a number of fiduciary duties to their clients that include duties to exercise reasonable care, to disclose conflicts of interest and to act in good faith. Asset managers must provide the information necessary for investors to make informed decisions and report regularly on how their investments are doing. These fiduciary duties also arise as a matter of common law, as a matter of statute and/or as a matter of contract. As a result, investors will have a remedy if there is any breach of duty, and the interests of fund managers and investors are aligned.

- **Protection of assets**

The assets of both UCITS and AIFs must be entrusted to independent depositaries, who are responsible for the safe keeping of fund assets. The UCITS and AIFM Directives require funds to appoint a depositary. In essence, the depositary, which is itself a regulated body, monitors cash flows and ensures that the dealing of units is carried out in accordance with national law and the fund’s rules and that the investment and valuation of assets is carried out in accordance with national law and the fund’s rules as defined in the fund’s prospectus. Ultimately, it seeks to safeguard against fraud, book-keeping errors and conflicts of interest between the fund manager and the fund itself.

- **Limited balance sheet risk**

Fund management companies do not act as providers of credit to individuals or corporations, nor do they provide custody or related functions. Fund managers do not act as counterparties in derivatives, financing or securities transactions. Moreover, they are bound by specific constraints as to the use of leverage and operations with borrowed money and are required to hold the appropriate and sufficient regulatory capital, which is supervised by their regulators. In this way, there is no asset-liability mismatch on their balance sheets, which remain very small compared to the balance sheets of banks and insurance companies.

- **Independent Oversight**

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<sup>10</sup> For example see Article 24 of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 On Markets In Financial Instruments and Amending Directive 2002/92/EC And Directive 2011/61/EU: “Member States shall require that, when providing investment services or, where appropriate, ancillary services to clients, an investment firm act honestly, fairly and professionally in accordance with the best interests of its clients and comply, in particular, with the principles set out in this Article and in Article 25.”

In addition to the appointment of a depositary, fund managers may (and are sometimes required to) appoint independent directors either to the board of the fund manager or to the board of an investment fund itself. Such directors are well placed to challenge issues that are not in the best interests of investors and to ensure that products offer value for investors.

- **Organisational Requirements**

Fund managers are subject to a comprehensive regulatory regime (underpinned by the Markets in Financial Instruments legislation and the sectoral legislation for asset managers (AIFMD and UCITS)), prescribing organisational requirements which impact fund governance. These requirements include processes (amongst other things) to address conflicts of interest, ensure continuity of service and mitigate operational risks arising from any outsourcing, and require fund managers to have (amongst other things) sound administrative and accounting procedures, internal control mechanisms and effective control and safeguard arrangements for information processing systems. Fund managers maintain comprehensive compliance policies and procedures to ensure their compliance with the regulatory regime. They perform regular testing of these processes to ensure compliance.

- **Risk management process**

Fund managers need to have an effective and robust risk management process in order to identify and manage appropriately all risks relevant to each investment strategy to which their funds are or may be exposed, notably liquidity, credit, counterparty and operational risks. Potential risks deriving from liquidity mismatches and the use of leverage within investment funds are efficiently tackled via the comprehensive regulatory framework consisting in the UCITS Directive and the provisions of the AIFMD and supported by a raft of more detailed implementation measures. Based on that, asset management companies are required to have adequate procedures and internal control mechanisms in place, as well as comprehensive compliance policies and procedures. In particular, for liquidity risk management the list of requirements includes: the need for an independent risk management function; monitoring the ongoing liquidity profile of assets within the fund; and disclosures to regulators and investors. Fund managers are employing a list of appropriate tools not just at a specific moment in time, but systematically and consistently throughout the lifetime of the fund, therefore implementing a corresponding liquidity risk governance policy both at the pre-launch stage, and at the post-launch stage. Last but not least, the conduct of stress tests both under normal and exceptional market conditions is a core requirement both for UCITS and AIFs.

- **Suitable Products**

Fund managers have a product approval and governance process which ensures that, for each product manufactured, an identified target market of end clients is assessed and, that when distribution of products is carried out (whether by the fund manager or by a distributor on its behalf), this target market



assessment is adhered to. Accordingly, it ensures that products are only distributed to those types of client for whom they are suitable. The close relationship between product functions and sales function ensures that products remain consistent and relevant to investors. It also allows managers to canvas opinion on product innovation (e.g. sustainable products).

- **Regulatory regime**

European and local regulatory regimes continue to improve and develop additional safeguards for investors and will continue to do so. In recent years, regulators have been increasingly focused on requiring fund managers to disclose costs and demonstrate the value to investors of their investment products. Managers are able to select the appropriate regime to provide investment solutions to different investor types with different objectives and risk appetites.

- **Transparency**

Over recent years, fund governance has increasingly focussed on ensuring that fund documentation is readily understandable (in particular for retail investors). The governance process followed by fund managers covers not only approval of prospectuses, but also the provision of short-form, key investor documentation. These documents help investors to understand and compare products.

- **Reporting**

Fund managers are required to provide, in respect of the products that they manage, regular reporting to depositaries regulators and investors. The existing regulation in the EU allows for an extensive monitoring, as both UCITS and AIFs are already bound by significant legislative and regulatory requirements vis-à-vis the regulators. The significant amount of data that is already required and submitted to the national competent authorities by investment funds and asset managers can help regulators achieve their key objective to better assess sources of risk and minimise the risks for potential future crises.

**Q8. Do you have any comments on the draft Impact Assessment? Do you have any evidence which could further enrich the draft Impact Assessment?**

**1. Policy issue 1: Providing relevant information on PEPP to consumers**

We fully agree that tailoring the approach for cost disclosure to the characteristics of the PEPP and therefore deviating from the approach taken under PRIIPs for cost disclosure is appropriate.

We also believe that the concept of RIY currently used to disclose product costs to retail investors is too complex for many PRIIPs. The fact that the costs include a time horizon and a yield assumption represents a new type

of theoretical disclosure that clients have not generally been familiar with. Its complexity significantly increases the risk that, at best, it is ignored by investors and, at worst, it is misunderstood by investors. This is especially the case for one-off entry costs as they are divided over the product's recommended period to hold the product, thus leading the client wrongly to assume that the impact on the initial investment is much lower than it actually is.

## **2. Policy issue 2: Implementing the cost cap for the Basic PEPP**

We believe that the impact assessment for the fee cap for the Basic PEPP should be strengthened by collecting more hard data on the costs of providing advice<sup>11</sup>. We strongly believe that the analysis will lead to the conclusion that the cost of advice should be excluded from the fee cap (see our comments to question 6).

Concerning the benefits and costs highlighted by EIOPA in its analysis of the costs that should be included in the fee cap, we have the following comments:

- **Concerning option 2.1 (introducing an all-inclusive approach)**

**In our view, the key question to be assessed is: will the 'all-inclusive' approach discourage all/most potential providers to offer the PEPP?**

EIOPA believes that this approach would only limit the feasibility and profitability of products and lead to reduced product availability for consumers due to challenges for PEPP provider to offer profitable products.

EFAMA disagrees with this conclusion. Our members are indeed convinced that **the 'all-inclusive' approach would prevent a viable PEPP market emerging at all. The cost of an all-inclusive approach is therefore much higher than that suggested in EIOPA's impact assessment.**

A critical point is that the cost of customer acquisition in retail markets is high. UK capped pension charges at 0.75% where automatic enrolment is used and the default is provided on a non-advised basis. This is a very different environment from the one in which PEPP providers will need to convince people to save in a PEPP.

Without the emergence of a meaningful PEPP offering, it would be meaningless to expect that the PEPP would achieve its main objectives, i.e. encouraging more competition in the personal pension market in Europe, reducing the fragmentation and current domestic nature of this market, achieving economies of scale and therefore offering good value for money, enhancing choice and encouraging more people to save for retirement, allowing portability of personal pensions and facilitating in this way job mobility in the EU.

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<sup>11</sup> We have provided additional evidence in our response to Question 6.

The irony is that the introduction of an inclusive approach to give access to a low-cost personal pension product would in the end prevent the PEPP market from developing. This would imply that consumers would continue to be offered existing high cost/low return national personal pension products. **EFAMA has a duty to make this strong statement while it is still possible to finalize the regulatory framework for the PEPP in a way that would make the PEPP really attractive for both consumers and providers.**

As explained in our response to question 6, **we strongly disagree with EIOPA's view that the possibility of providing advice through an automated system should be considered as a mitigating factor.** As it is established that the majority of savers will want to receive advice from a human financial adviser, together with the complexity and expertise of assessing existing pension provisions, PEPP providers will need to offer this service to offer the PEPP and take into account the costs that all this involves.

Against this background, we recommend that EIOPA proposes to exclude the cost of advice from the fee cap, following in this way the approach it took for the cost of guarantee.

**As for the cost of guarantee, we cannot find the data used by EIOPA to conclude that the cost of guarantees should be excluded from the fee cap.** While we agree that *'including the guarantee in the cost cap will probably have the effect to decrease the number of products in the European market and the possible choices to be made by the savers'*, we do not understand why this judgment leads EIOPA to conclude that the cost of guarantees should be excluded from the fee cap.

- **Concerning option 2.2 (excluding distribution costs)**

We agree that the cost of distribution (including the cost of advice) represents a significant percentage of the total cost of a personal pension product.

It would be ideal if the PEPP could be offered under an auto-enrolment regime. This would indeed reduce the cost of distribution of the product. As it is not foreseen that Member States will automatically enroll their citizens into a program of saving in the PEPP, PEPP providers will have to rely on distributors and face-to-face meetings/individual calls to convince people to contribute to their PEPPs on a voluntary basis. This implies a cost that needs to be taken into account in the preparation of the Level 2 measures.

To address this problem, we propose the following solutions:

- The cost of distribution and the cost of advice should be shown explicitly and separately in the PEPP KID in order to inform consumers and reinforce the competition between PEPP providers, distributors and advisers.

- The cost of advice should be exempted from the fee cap, at least until the first review of the implementation of the fee cap, in order to offer some degree of certainty that the PEPP market is going to develop. However, to put further pressure on providers, EIOPA should gather information on the cost of advice on pensions, including the cost level, the nature of the services offered, the methodology used to calculate the cost.

### **3. Policy issue 3: enabling appropriate risks and rewards**

As explained in our response to Question 7, we agree with the approach taken by EIOPA to assess which approach should be followed to regulate the risk-mitigation techniques.

**Q9. Do you have any other general comments to the proposed approaches?**

**Q10. Do you have any views on the opportunities for PEPP in a digital environment, for example regarding digital information provision and online distribution?**

We believe that the regulation should allow for the provision of the PEPP KID and Benefit Statement by digital means in a way that permits the layering of information. The core requirements (such as summary risk indicator, presentation of cost, past performance and performance scenarios) should be presented in the first layer. All other information can be detailed in subsequent layers.

Consumer insight should inform design decisions. Consumer testing is essential to understand how to engage savers with their pension savings early on so that they get the information they need to determine if the product is providing value for money. A digital version of the PEPP KID should also be tested.