French Pensions Framework in an International perspective

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Pension payments represent a growing part of GNP in all modern economies. Their social and economic impacts are key to all stakeholders. Although pension systems have been in place now for several decades, they remain a recent development historically, as most of them were created after the Second World War. It is therefore useful to try to assess their efficiency and to compare them internationally. Why not considering positive features and unforeseen risks faced by schemes from other countries? Obviously the very low interest rate environment poses great challenges to any funded system, but at the same time, unemployment combined with increasing life expectancy puts stress on pay as you go systems. What are the recent contributions in the debate on pensions in a country like France, where the limits of the welfare system are now clearly visible? Finally, public understanding of these notions is beginning to be better addressed, and with good reasons, by specialists and politicians: what is the relevant information to disclose and do people have the knowledge to put this into perspective? Here are a few reactions to another article published in this BM&I issue, Theo Nijman's contribution on Dutch pensions.

How to assess pension system efficiency

In a recent interview for the Financial Times, Ruston Smith, chairman of the National Association of Pension Funds in the UK stated: "I am after simpler, more flexible and better value pensions that people trust». Indeed once saving amounts are set, the requirement from the benefiters (savers to become future retirees), falls into three categories: flexibility in allocation and aggregation during the career path, value of the pensions during retirement period, and finally trust coming from the sustainability of the system and the reliability of the information". These considerations were clearly part of the debate on reforming the pensions in the Netherlands and were also at the core of the discussion in the continuous adaptation of the French system, in particular since the Charpin report twelve years ago. But every system has its own history which, given the time span of retirement, remains quite short. A century ago, families were caring for elderly people who had or had not saved for themselves. Wars and inflation have destroyed part of the accumulated wealth during the first half of the last century. Only post war experience can help assess the efficiency of these systems. Most systems can be depicted by three pillars. The first one, basic pensions, is compulsory and in Pay As You Go (PAYG). The second pillar, also compulsory, is either PAYG as in France or funded like the English system. The third is voluntary and funded, with a large variety of products. The financial performance of PAYG systems depends primarily on growth of the employed population and of the wages. The performance of funded systems depends on real return of financial and real assets, thus interest rates and some form of premium related to the riskiness of the assets. To assess performance, it would be worth creating benchmarks and comparing them with actual performance. Indeed in the case of PAYG, the existing benchmarks, which are overused by the financial industry, should not necessarily be considered, because they should measure the customer usefulness throughout his life (accumulation phase and pension phase). As Nijman rightly points out, the interest rate risk between the two phases when buying an annuity for example, shows that even if the financial performance were great in the first phase, the pension amount can be limited if interest rates are very low, as they are presently. Creating appropriate measurement tools seems an obvious start. It would help to look at the implementation cost in a more effective way, separating what comes from the fundamentals and what is related to the services provided by the schemes.

When it comes to flexibility, qualitative judgment will come to the fore. Possibility to select the provider or to change the asset allocation would be considered important to individuals with sufficient knowledge of economics.

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Most people would want to have flexibility during their career to keep track of their savings. Finally, the possibility of having a certain amount paid in lump sum, in order to buy a house for example, is another important aspect savers often require. In many countries, savers disregard annuities because they feel trapped in a system that is inflexible and might be too tied to the guarantor. These features might be less relevant for international comparisons.

Finally, trust is clearly a critical element even though difficult to compare. The system itself is an important component, the state of the system, and finally information on the system are key elements for building trust. Of course guarantees offered to future pensioners have a value, as well as the stability of the real income stream delivered. But the focus tends to lean now to the information given to future pensioners on their rights and estimates of their future income. This is discussed in Nijman and is in every country a subject requiring great attention. It will be detailed later.

New directions in France

As the French scheme is predominantly PAYG, its sustainability is endangered by many factors. Aging hurts all schemes simultaneously. Unemployment rate is far higher than the one experienced in the past and in actuarial projections. Two factors tend to lower the pressures on the system: population growth which is higher than in neighboring countries and real wages which have been rising despite the crisis. Nevertheless, the recent troubles in government debt have clearly sent the signal to the population that the state can no longer grant the same benefits as in former welfare system. In addition, everyone also knows that the average pension is similar to, or even higher than average wages, thus time is ripe for moving… and governments try to do so but at the speed of a tortoise, given the possible consequences. Large strikes in the past have deterred many politicians from acting as quickly as the sustainability of the schemes would have needed. The main attempts were recently made in increasing the age of full benefits which has risen steadily and will probably continue at a rate of a quarter every year, which is not that far from the aging trend. For political reasons, the official retirement age remains at 60, which seems very odd compared to other European countries. In the last decade, a very interesting move towards funded systems came from the civil servant scheme, a bit of a surprise given the strength of the unions there. Indeed ERAPF was created to fund pension rights for civil servants on their additional incomes, bonus and other payments which were not covered by a pension scheme. Since 2005, a provision is taken on these payments and funds the equivalent of a dedicated pension scheme. The reserves have from that moment on risen to 13.5 billion Euros with 2012 inflows of 1.75 billion Euros paid by 4,5 million persons. This could serve as a template for the private sector.

Unfortunately the ideological debate on a funded system is still blocking change of that sort. Yet the saving rate in France is around 16.5 %, among the highest in Europe and life insurance wrapper around long term savings is the population's pet product. In order to allocate the 1.7 trillion Euros saving pool that has build up in the last two decades, a recent report written by two members of the French Parliament, Berger et Lefebvre, has proposed a new life product that would extend the one year guarantee given to traditional life products, to longer maturities. If this product is indeed created without too many complex details that have mired previous products, this new "contrat euro croissance" could be the building block of a funded third pillar. In reality, most of the life products are now invested into bonds in order to meet the yearly guarantee. A longer maturity would allow a more dynamic asset allocation, and thus a higher domestic funding of the private sector. Indeed, new products developed in other markets can foster creativity. Thanks to favorable tax treatment, many "systèmes en points", another insurance product L441, have grown over the last decade, but the amounts saved will far from compensate the reduction of pension paid by the compulsory PAYG. Opting out from the compulsory system is a new proposal that left leaning advisers have proposed recently. All actions taken will not suffice to maintain the benefits that former generations enjoyed. French politicians cannot disregard any option, given the state's debt. Can we expect good surprises?

Information and education are key

Individual and social impacts of pensions are too important for neglecting communication aspects. I would claim that progress has been made on information despite more awareness on potential risks and I would suggest that remediating actions are needed. Where we fall short, in France at least, is on public education.

Information on pension rights are now available to workers over the age of 50, and regular information about second pillar entitlements are sent by Social Security and Caisses de Retraite. Clearer documents and better accessibility to such information would certainly help, for example the rules for determining future pension as a function of retirement age. But as Nijman points out, there is a need for sensitivities, or even in the case of second pillar pension, indication of the factors that may influence reduction in pension payments. Some sort of comparison with wage variations and inflation should at least be given.

More importantly, if action from the future retiree is needed -additional savings for example- there is no guidance given as to the type of investment which would compensate the future gaps. Amounts, inflation protection and interest rates, which impact on investment decisions, should be shown in an accessible manner. This lack of guidance is amplified by the poor level of economic knowledge among the French population. In a European survey carried out three years ago, the French sample scored the poorest on even simple questions like: «what is the income of a product with 2% annual return after one year?". Less than one in two of my fellow citizens were able to provide the right answer. This is not an isolated situation, as a more recent survey carried out in the USA shows: less than 30% of a very large sample of individuals was able to correctly identify what consequence an interest rate rise on bond prices would have. Many generations miss the basics in economics and finance that were taught to their grandparents at the beginning of the 20th Century. There is a state of denial surrounding these issues, and efforts have not been adequately targeted on the savers because the amount of savings is large. Nevertheless the allocation of savings is far from optimal for the savers themselves and for the economy at large. The Berger Lefebvre report points in the right direction, as far as products are concerned, but unfortunately misses the point on education. How could the savers invest their precious savings without understanding the mechanism? True, many providers offer guidance, but it is often tweaked to tax consideration that complicates rather than helps long term allocation of savings. How can people understand the prospects if they do not have the minimum required knowledge of financial investments? Unfortunately, savers buy at the top of the market as is clearly documented in France by the mutual funds flows of the last decade.

International comparisons could indeed foster better product development, more flexibility for the future retirees and better reporting of future entitlements. In particular some form of benchmarking would help to design the most appropriate allocation strategies and the right balance between PAYG and funded systems. It is a topic that neither financial provider nor politician can disregard. I hope that, as in the Netherlands, academics alongside practitioners will be involved in these matters that are often discussed by stakeholders with, at times, insufficient expertise. In particular I think financial education would help everyone cope with the challenges of pension schemes all over the world. ■