Analyses Économiques vol. VIII-05 (Sep. 2009)

The Newsletter of the French Council of Economic Analysis

The CAE is an independent, non partisan advisory body reporting to the French Prime Minister, whose members belong to the academic community, as well as to the business and government sectors. Reports issued by the Council represent the views of their authors only, not those of the CAE (which does not take policy positions) or of the French government. The reports, which are published together with comments by discussants and background papers, can be downloaded free of charge from our website www.cae.gouv.fr. Each issue of this newsletter, which is released by the Council's permanent staff, focuses on a particular report.

Saving for the Long Term and Managing Financial Risk

Report by Olivier Garnier and David Thesmar

«Where have all your savings gone?» ran the headline of the British weekly The Economist at the end of last year. 2008 was not only the worst year on the stock markets since the 1930s, but the decade from 1998-2008 also saw equities yield negative real returns. The repercussions of the shock are not the same in each country. In Anglo-Saxon countries, doubts have arisen about the stability of funded pension funds. Other countries, such as France, currently appear happy to have a pension system built almost exclusively on redistribution. However, on the whole, the French are also savers with a financial wealth of over EUR 3,000 billion. And they also have an increasing need for high-performance savings to offset the inevitable decline in the replacement rates of pay-as-you-go financed public pensions.

How in the future will households be able to obtain sufficiently high-yielding long-term saving without being excessively exposed to financial risks? What role can and should public policies play in helping savers face this challenge? The report by Oliver Garnier and David Thesmar

EDITORIAL

The current crisis has a tendency to shorten the horizon of most economic decisions and to reduce the appeal of some risky financial investments. It does not however invalidate the key principles of good financial management.

This report focuses on the viewpoint of individual savers. It takes as its starting point observations about the financial wealth of the French, informed by international comparisons. Cash savings and life insurance account for the lion's share of investments. French household investment in equity markets remains modest compared with international trends.

Saving policy must encourage households to save more effectively over the long term. In order to prepare for retirement, the complementarity between PAYG and funded pension systems needs to be exploited. Saving policy must promote a taxation system that is neutral with regard to different financial products

Christian de Boissieu
Executive Chairman of the CAE

What are the right principles for saving policy?

The authors approach the topic of saving from the standpoint of the needs of household savers rather than that of the financing of the economy. Thus it is a question of studying the opportunities, risks and constraints (behavioural, institutional and financial, etc) that households face in optimising their consumption profile throughout their life cycle. In this way, Olivier Garnier and David Thesmar are at odds with the traditional approach to saving policy in France, which has hitherto given priority to concerns about the financing of the national economy. Household investments have been directed towards social housing, privatisations, budget deficits, listed companies, non-listed SMEs, innovation, French overseas departments and territories, cinema and forests, etc, in order to reflect current priorities. Hence the proliferation of systems serving not households directly, but rather the sectors that their savings finance.

This approach finds its roots in the interventionist investment policies carried out by the French government after the Second World War, an era when the financial markets were still underdeveloped and poorly integrated at the international level. It is also closely linked to an inherited vision of the Welfare State, in which the management of risks affecting households is almost exclusively a matter for social welfare and national solidarity systems.

Households at the centre of saving policy

For Olivier Garnier and David Thesmar, the globalisation of capital markets, on one hand, and the increasing struggle of social welfare systems to provide adequate protection, on the other, demands that households be put back at the centre of saving policy concerns. Obviously, this is not to say that the problems of financing the national economy are no longer important, nor that saving policy should no longer be at all concerned with them. But they should no longer be given priority over the needs of households.

The authors' recommendations relate to the balance between fund-based and pay-as-you-go pension systems, the taxation of savings and the correction of behavioural biases affecting the saver.

The financial wealth of French households…

The first part of the report outlines the key facts about the financial wealth of French households. At the end of 2007, it stood at almost EUR 3,500 billion and represented one-third of total wealth, including housing. The first available figures show how the financial crisis impacted this wealth in 2008: a drop of some EUR 200 billion mainly due to asset depreciation from falling prices. In late 2008, the gross financial wealth of households represented around 2.5 years worth of their disposable income.

This wealth is divided into four major types of financial investments. Liquid saving (outstanding balances on saving accounts and money market funds) represents more than a quarter of financial wealth and has benefited from the recent financial context. Contractual savings (home savings and 'popular' savings plans) are in marked decline and account for less than 10% of financial wealth. Life insurance continues its sharp rise with a share approaching 40%. Securities (bonds and shares) held directly or indirectly (investment funds) have shrunk to less than a quarter of financial wealth, victims of the capital losses of the financial crisis.

… is focused on liquid or low-tax investments

In fact, the French favour liquid financial investment with no (or little) taxation. Equities have a minority presence in their portfolios; besides, less than a quarter of French households own them, directly or indirectly. In international comparisons, the scale of financial wealth of French households as well as the distribution of equities within the population appears smaller than in Anglo-Saxon and north European countries.

The composition of the portfolio has implications for its profitability and thus for changes in levels. For example, the authors show that between 1994 and the end of 2008, both US and French households saw their outstanding financial balances multiplied by 2.16. In the United States, this increase was more the result of valuation effects arising from capital gains on risky investments rather than saving efforts. The opposite applies in France. The effects of the financial crisis only partly alter this fact.

Pension systems and financial wealth

By making international comparisons, Olivier Garnier and David Thesmar show that differences between countries are largely explained by the way pensions are paid for. Families in countries where capitalization schemes are very widespread have twice the financial wealth of households in countries where pay-as-you-go system is dominant. Under these circumstances, it is not surprising that countries with a high rate of funded pensions tend to export equity capital and to receive dividends while the opposite is true of countries where unfunded systems dominate.

Risk and return of equities in the long term

Should household savers be advised to invest in equities for the long term?

The second part of the report re-examines the question of risk and return on equities from a long-term viewpoint. As far as Olivier Garnier and David Thesmar are concerned, the 2008 crisis does not undermine the advantages of investing in equities on a long-term view, but it does correct the common misconception that equities are not risky if held long enough.

To support this argument, the authors carry out a careful comparative analysis of the real returns of various investments (equities, bonds, money-market investments) since the nineteenth century in a large number of countries. First point: over a period of a century, the real premium paid to holders of equities averages 3.5% per annum over bonds and 4% over money-market investments. The average superiority of equity investment over the period does not exclude less profitable sub-periods, particularly in Europe and Japan.

From the viewpoint of portfolio management, it is vital to examine whether the average excess return on equities has been matched by higher volatility (and therefore risk). This leads to the authors' second point: the *relative* risk of equities relative to bonds and money-market investments tends to diminish as the term of investment lengthens. This decrease stems from changes in the equity risk premium, which is affected by the phenomenon known as 'regression to the mean'. Since good performances tend to herald not-so-good ones, increasing the term of equity investment decreases cumulative return risk.

What are the consequences for the long-term portfolio?

These factors support direct or indirect shareholding by households saving for the long term. However, this conclusion comes with several reservations. First, the long term can sometimes be longer than what a lot of savers can endure. Secondly, it is the relative risk associated with equities (compared with bond or money-market investments) rather than absolute risk that decreases most significantly with the investment horizon. Finally, the risk and long-term return outlook of equities is not invariant, but depends crucially on their initial valuation. This last factor means that households cannot simply «buy and hold'. On the contrary, it is essential to exploit the return/risk properties of equities over the long-term and to regularly revise allocation based on foreseeable future returns and the residual investment horizon.

From the latter point of view, the risk/return profile of equities following the financial crisis is currently more favourable for a long-term saver than it was ten years ago.

Four recommendations for optimal management of household portfolios

The third part of the report reviews the normative recommendations arising from the economic literature and compares them with the actual behaviour of savers. Four major recommendations emerge from the theory. The first relates to the need to diversify the portfolio within an asset class and between asset classes. The second notes that past performances are not a good selection criterion for investment funds and that the level of management fees is more important. The third recommendation is linked to the investment horizon, which is crucial in choosing a risk/return profile. Lastly, the fourth and final recommendation is to take into account non-financial assets (property, future earnings and PAYG pension entitlements) in the selection of household financial asset allocation.

Choices bear little relation to the recommendations

It appears that households' spontaneous investment choices often bear little relation to these recommendations. In terms of direct stock market investments, savers diversify too little, execute too many transactions and invest too pro-cyclically. Furthermore, if they invest indirectly through investment funds, too much importance is given to past performances, whereas management fees ought not to be overlooked. Lastly, exposure to equities should most often decrease with age. However, many young wage-earners hold fewer equities than this principle would suggest, because they are buying a main home, because of debt constraints or because of insecure income or employment. From the viewpoint of such 'human wealth' risks, the expansion of social insurance in France (particularly unemployment) ought to direct saving towards risky assets such as equities. Comparisons with the United States thus lead to a contradiction, which is explained by differences in the pension systems.

Which saving policy?

The fourth and final part offers recommendations for saving policy. Olivier Garnier and David Thesmar suggest that these recommendations are based on two principles:

- the first objective of saving policy must be the well-being of households from a life-cycle point of view;
- public intervention in the area of saving must aim to correct market failings and behavioural biases among households, particularly in order to provide protection against risks that are not insurable by the markets or in order to remedy liquidity constraints.

The principles set out above lead to three key directions concerning pension systems, taxation of saving and the behavioural biases of households.

Developing universal funded pensions as a complement to the PAYG system

In terms of pensions, it is not appropriate to create an opposition between PAYG schemes and defined contribution funded systems, but rather to take advantage of their complementarity. Olivier Garnier and David Thesmar believe that one way of exploiting this complementarity is to increase the weighting of funded provision for younger people and to subsequently decrease it in favour of PAYG over the course of the life cycle. This type of strategy has the advantage of exposing younger generations to more financial risk and older generations to more wage risk.

Arguing for the stabilisation of contribution rates under basic PAYG systems, the authors suggest that defined contribution pension savings be expanded in order to deal with the forseeable drop in replacement rates. Since these retirement savings would supplement the annuity received, mainly, under the PAYG system, it would be logical to promote risky investments (equities) decreasing with age, and to leave the choice of exit mode (lump sum versus annuity) optional.

In order to encourage people to build up pension savings early, Olivier Garnier and David Thesmar suggest that the state pay a bonus that reduces with age that would supplement payments to PERPs (French popular retirement savings plans) or PERCOs (French collective retirement savings plans).

Aware of the difficulties of encouraging those on lower incomes to build retirement savings, the authors recommend redirecting FRRs (French pension reserve funds) towards the funding of small pensions.

Instituting a more neutral tax system on savings

The taxation (including social contributions) of savings is highly complex, muddled and unstable. It juxtaposes multiple exceptional and specific systems, which reflect the gathering of measures over the years rather than an overall logic. Most importantly, it introduces unjustified distortions in favour of certain liquid or low-risk investments. Moreover, unlike social contributions (which currently represent more than two-thirds of the proceeds of levies on saving by investment in securities), tax on securities rests on a very narrow base: less than a third of income and capital gains on securities is taxed at income tax rates as a flat rate withholding tax.

The authors recommend promoting greater neutrality between products rather than introducing additional incentives to encourage investment in equities. Their preference is towards a tax on savings (including social contributions) with a single tax base and tax rate, a flat-rate personal allowance (which would replace the tax exemption on saving account interest), and exemptions or deductions for long-term frozen savings only (PERP, PERCO or life insurance-type products). Assuming that receipts are unchanged, this single rate could be between 15 and 20%, depending on calculations.

Correcting biases in household behaviour

Government actions must take into account the often highly counter-intuitive nature of financial decisions as well as behavioural biases. The authors cite numerous studies that show behavioural errors relating to both the level of long-term saving and the composition of the portfolio. Because of these 'investment errors', improving financial education is absolutely necessary, but it is not a miracle cure. In this domain, a certain amount of 'liberal paternalism' on the part of public powers and the distributors of financial products is desirable, notably through the introduction of default options. Such options would relate to the membership of a retirement saving plan and the adjustment of asset allocation over the life cycle.

Comments

Roger Guesnerie liked the authors' efforts to gather factual information about long-term saving and the financial risks that households are exposed to. He also feels that the report successfully reconciles empirical evidence and theoretical perspectives.

However, he is more sceptical about the authors' key principle that the primary concern of saving policy should be households rather than the financing of the economy. He feels that not enough proof is given for this argument even though the opposite principle has, it seems to him, been dominant in the past and even though recent events show that the reality of the nation is still important on both sides of the Atlantic in terms of the direction of financing. While Roger Guesnerie is not opposed to this principle, he believes that the ingredients of the report are insufficient to withstand rebuttal.

As far as theory is concerned, the report could have placed more emphasis on issues of credit constraints rather than behavioural responses to risk in explaining the level and composition of wealth. The existence of these constraints challenges the idea that young households ought to steer their financial savings towards equities. Finally, Roger Guesnerie subscribes to the need to seek the right balance between PAYG and funded pension systems in order to manage the distribution of risk between employees and pensioners.

Jacques Delpla supports the approach and arguments of the authors in terms of the taxation of savings. The current mechanisms send conflicting signals to households and thus damage effectiveness. The introduction of a flat tax is a convincing solution that would clash with a number of interests constituted by the collection of systems. In order to get around this difficulty, Jacques Delpha suggests that the reform should not affect the existing stock of savings. He is against the authors' suggestion of granting special tax advantages to young savers. The question of the distribution of savings products and competition is tackled in the commentary. Bearing in mind the current wave of bank mergers, Jacques Delpha is in favour of a strict separation (a 'Chinese wall') between retail banking and asset management. In this way, each network would be obliged to open to competition the in-branch products that it sells to end savers.

La documentation Française
113 rue de Grenelle 75007 Paris (FRANCE) Ph.: (33-0)1 42 75 53 00 – Fax: (33-0)1 42 75 51 27
Publisher: Christian de Boissieu – Editor: Pierre Joly – Electronic Publishing: Christine Carl