COUNTRY SPOTLIGHT FRANCE

Calm before the storm

As the cost of pensions continues to significantly impact on France's economic growth, Peter Davy **explores the reforms that may be required to the pension system**

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France is not Europe's sick man, its Prime Minister Manuel Valls recently insisted. However, it is then hard to know who is. The country's national debt hit a new record in the second quarter, topping €2 trillion, at 95.1 per cent of country's GDP, according to the official statistics agency. Unemployment is at new levels, too, according to the latest figures, with the number looking for work at 3.4 million in October – 11.1 per cent.

And there is little prospect of immediate improvement. The European Union Commission economic forecast in November put France as the zone's weakest performer. Despite better than expected growth in the third quarter, the deficit is expected to continue growing in the New Year. At the end of November, the Commission put on hold its decision whether to penalise the country for failing to meet Eurozone rules on keeping deficits to 3 per cent. France's is expected to be 4.3 per cent.

France, it said, had made only "limited progress" in reforming to meet the rules, it noted.

"Government debt has increased in a lot of countries, but the situation in France is particularly significant. There is always Japan, of course, doing worse, and then Greece and Italy, but France is in the top eight to ten," says Hervé Boulhol, senior economist for pensions and population ageing at the OECD Directorate for Employment, Labour and Social Affairs.

This is a long term trend, says Boulhol, and it is mostly down to an increase in public spending, not lower tax revenues.

"And if we look at what have driven the increasing spending, it is pensions and health care," he adds. The OECD's update in November puts France as the leader in terms of public and social expenditure, spending 31 per cent of GDP in 2014. Of that, 13 per cent – the largest part – is pensions.

"The easiest way to decrease public spending is to reform the pension system," says Nicolas Bouzou, at Paris-based economic consultancy Asteres.

A retirement age of 64, a contribution period for a full pension of 44 years, and this package of reforms implemented by 2024 would make the system sustainable, he argues.

"Economically it is not very complicated. The problem is a political one."

Not so easy

It is not as if French governments haven't tried. There have been a number of reforms in recent years. Most recently, reforms passed last December rose the contribution period required for a full pension to 43 years (but only between 2020 and 2035), and announced a 0.3 per cent increase in contributions by employees and employers by 2017. It also fixed pension increases for existing retirees at one percentage point less than inflation, effectively freezing them this year since inflation is still only 0.5 per cent.

It is not enough, however, according to Bouzou.

"It was not real reform; it was an adjustment," he says.

"The parametric reforms engaged until now have been too timorous to address the important issues and a structural reform appears inevitable," agrees Anne Reimat at the University of Reims.

The figures support that. The reform was designed in part to make the compulsory occupational pensions system – the Agirc-Arcco, which runs alongside the social security pension – affordable. However, a report in December suggested they have had little effect on the reserves for the system, which are expected to begin drying up in 2017.

The result, says Sandrine Gorreri, retirement expert at think-tank iFRAP, is that more reform should be expected, perhaps as early as next year – this time to tackle the pension age, which the December reforms left at 62, but which, she argues, needs to rise to 65. If that happens, however, it will further undermine confidence in the main pillars' sustainability.

"The pace of reform is accelerating," she says. "We had reform in 1995, then 2003, 2007, 2010, 2013; the next will be 2015. People don't trust the system any more."

Mix and match

They are not lacking in alternatives.

As well as traditional employer sponsored, insurance-based schemes in France – either 'Article 83' (DC) or 'Article 39' (DB) plans – there are also the newer occupational and personal savings plans – the Perco and Perp, respectively.

All, however, remain small compared to assurance de vie contracts (literally 'life insurance' but actually a long-term savings programme) that still dominate French savings. Net inflows into these are €17 billion year to date, according to the FFSA, the French insurance association. The Perco market, meanwhile, is worth €9.7 billion, overall.

Pension savings in France ranks a fairly distant third in people's priorities, according to Florent Delorme, senior sales manager in France's M&G Investments: "People in France will first try to buy their house, then buy life insurance and, third, put money into a Perp or Perco."

It would be a mistake to dismiss the industry, however.

For a start, workplace saving overall is not that small. There is €80 billion in Article 83 and Article 39 plans to add to the Perco figure, and €10.4 billion in Perps at the end of 2013, as well as €104.4 billion in Plan d'Epargne Entreprise (PEE) schemes (company-based savings schemes, which are shorter-term).

"The overall environment represents altogether over €200 billion of assets, so it's not a small industry," says Cécile Advani, head of strategy for BNP Paribas corporate savings and investment solutions.

Moreover, the money in Perco is growing rapidly, up 14 per cent in the first six months of 2014, according to Nada Kada, head of business development for Amundi Employee Savings and Retirement, which provides Perco funds and administration and is a market leader with a 35 per cent share. Growth is driven by two factors. First are the fears over the state-sponsored pensions, with Amundi's research showing 82 per cent of young professionals lacking confidence in the future of the public system.

"Employees are increasingly aware of the importance of the occupational pension schemes," she says.

Second, is Perco's flexibility, which appeals. Employees, for instance, can choose either a lump sum or annuity at retirement, and can also access the money early to get on the housing ladder – giving it the edge over traditional insurance-based DC plans.

"Telling young employees they should contribute from the age of 25 and then they have to wait for retirement to get their money back can put them off," says Kada. Over four million people have access to a Perco, and more than 1.5 million have already contributed themselves.

It is not all one way. Tax rises in 2012 on contributions to corporate savings plans, for example, have reduced the efficiency of pensions for high earners, making it more efficient for many businesses to instead increase salaries – often coupling this with financial advice.

"Where things are moving to is that rather than targeting a specific replacement ratio through a pension plan, companies look to help employees build wealth when in activity to a level that will allow them to maintain the equivalent standard of living when in retirement," says Mourad Bentoumi, pensions department leader in France for consultant Towers Watson.

Indeed, Reimat argues that the increase in Perco savings is largely due to the reduction in tax breaks for other savings.

However, for others the work with higher earners is part of a wider trend in which consultants are working with businesses to maximise the efficiency of a wide range of options as increases are seen across workplace savings vehicles.

As Isabelle Hernu-Sfeir, senior consultant in Mercer's retirement business in France, explains, companies may have an Article 83 plan, a Perco and a PEE – as well as a compte épargne-temps (CET), a vehicle to save the value of untaken holiday. Solutions to French retirement increasingly involve them all.

"All have different rules, limits and fiscal incentives so there's plenty of scope to optimise the way they are used. We are advising companies how they play with these different systems. You need to look at it as a whole, rather than on an individual basis."

Investment strategies

AS WELL AS looking at benefits provision generally, corporates are also looking at the allocation in their schemes, according to Erwan Boscher, head of European pension solutions at AXA Investment Managers.

"We are seeing corporate sponsors, whether of DC or legacy DB schemes, doing a lot of work to structure their risk management and asset allocation processes," he says.

Generally, that means making them more dynamic and diversified – including exposure to some alternatives.

"LDI and derivatives are having a very gradual take-off, even if it is not the best entry point at the moment in terms of interest rates," he says. "There is more realisation that there needs to be risk management and that the allocation needs to change to adapt to new market conditions."

That's obvious in the DB world, and now it is also 'trickling down' to DC schemes, with more sophisticated solutions there. Schemes are moving towards a bit more open architecture, and increasingly include absolute return or some diversified growth funds solutions.

Jean-Marc Didier, commercial director of institutional clients and businesses at Fidelity in Paris, meanwhile, says the domination of the life insurance products is being challenged by falling yields. Instead there is increasing demand for income products and balanced products to provide for medium to long term savings.

Institutional investors, meanwhile, looking at French – and wider Eurozone – challenges are reviewing their geographic diversification.

"There is increasing consideration about where growth will be generated going forward. A lot of institutional clients are still mainly invested in European assets and there is a realisation they will have to look at the US and Asia. After a pretty volatile 2014 year there will probably be some reallocation from Europe to those two areas."

Such issues mirror the concerns of those managing the reserve funds for the Agirc-Arcco, and other compulsory state schemes.

For these, says Anne-Laure Frischlander, BNY Mellon IM managing director for France, asset liability matching, but they face considerable challenges – not least in the restrictions they face. Agirc-Arcco funds, for instance, can only invest in OECD countries and are prevented from areas like currency management.

"There are lots of restrictions that do not allow them to capture a wider range of returns."

As a result, the funds remain significantly overweight in French and euro equities –once again tying the pension to the country's fortunes.