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FROM DEFINED BENEFITS TO DEFINED CONTRIBUTIONS: A NEW CHALLENGE FOR ASSET MANAGEMENT

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There is no longer any question that pension funding is one of the main problems facing society in the future, largely because of the faster ageing of the population. It is also clear that household savings will have to contribute more to the solution of this problem in developed countries. One of the major consequences of this is that, increasingly, a large portion of the financial risks borne collectively under existing systems will be transferred to individual investors. This will confer an expanded role and greater responsibility on fund managers.

Indeed, cumulative external risks – adverse demographic changes, rising life expectancy, the anticipated impact of economic dependency problems, rapidly changing technology and therefore employment and the increasing instability of business location – are such that government bodies (social security) and public and private companies (pension funds, etc) are unable or unwilling to shoulder these risks alone, at least in the traditional form of “defined benefits” These "established players" no longer feel capable of promising employees a pension in proportion to earnings or, on even more generous terms, their end-of-career earnings.

For these reasons, and amid growing concern and awareness among future pensioners, we are currently witnessing growth in complementary schemes, usually individual plans involving insurance-based products or using the structure of investment funds (IRA or 401K[1] in the United States) known as “defined-contribution plans”. Their purpose is to provide future retirees with income from investments and savings built up over their working lives, ensuring the highest degree of security and performance. This apparently inevitable development has produced a major change in the allocation of the financial risk embedded in these investments. Whereas in the recent past, risk was largely borne collectively – whether at the national or corporate level – in the current period, it is increasingly individuals who directly bear the risk in their portfolios. Individuals must not only anticipate and shoulder part of the longevity risk inherent in all pension systems, but must also make decisions concerning the allocation and selection of high-performance assets in order to ensure a level of retirement that is consistent with their future needs. In reality, these tasks are handled to a large

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extent by insurance and asset management companies, which are awarded a mandate. Given the considerable volumes that need to be managed amid the "securitization" of economies and increasing transfer of risk, this responsibility represents a challenge and a major change for the asset management industry. This trend is particularly important for the French investment management industry, which in terms of investment funds ranks number two in the world and number one in Europe.

The change in the identity of risk bearers, which is central to the issue of complementary pension funding, is based on the shift that we have seen or are currently seeing in at least three closely interlinked paradigms. The first is the transition from an intermediated economy to a market economy requiring stronger means of securing and increasing wealth. The second confirms the transition from defined-benefit to defined-contribution regimes. The third change concerns the ongoing shift from precautionary savings, largely designed to "provide comfort" in retirement, to investment intended to increase wealth over the very long term. Finally, a fourth paradigm shift, which we look forward to, concerns the efficiency of the state itself, which has a duty to demonstrate a stable, long-term commitment to balancing consumption and savings without giving in to the common temptation to see savings as an obstacle rather than a contributing factor to consumption.

DISINTERMEDIATION TRANSFERS MARKET RISK TO HOUSEHOLDS: IMPROVING INVESTOR EDUCATION AND GOVERNANCE

The shift from an intermediated economy to a market economy implies that households – and therefore investors – directly shoulder the risk existing in financial markets via their portfolios. This contrasts with the situation that prevailed within the intermediated economy, in which – as the name suggests – the major share of financial risk was shared among intermediaries instead of investors or savers. It should be noted, however, that while the chain of risk-bearing intermediaries was long (governments, social security, banks, insurance companies, firms, defined-benefit pension funds, etc), when major risks did materialise, it was in fact households, particularly as taxpayers, that ended up footing the bill for deficits or losses via government subsidies or the state guarantee mechanisms.

Noting this now massive transfer of risk to the household sector, international bodies such as the IMF and OECD are quite rightly calling for vigilance and highlighting the need for an improvement in current standards of governance and accountability. According to the International Monetary Fund (IMF – March 2005), while the transfer of risk has a positive dimension, mainly because it encourages price formation[2] by making the markets more liquid and increases the supply of high-performance products aimed at increasing the value of managed portfolios, it could ultimately weaken the stability of the financial system unless a system of governance for households' growing exposure to risk is established.

Raising the level of financial education of households, and investors more generally, and increasing emphasis on financial advice (at present relatively limited due, among other things, to households' reluctance to pay for this type of service) appear to be key recommendations of the IMF. National regulators such as the SEC in the United States and the AMF in France are also concerned about this issue. The AMF has just published a set of recommendations in this area[3]. As for the OECD, member countries approved new guidelines in April 2005, intended for the time being as additional recommendations to the OECD Principles of Corporate Governance "aimed at insurance companies and pension funds in order to strengthen investor confidence […] and safeguard pensions from the effects of mismanagement…". This seems all the more essential as these funds, which manage assets worth more than USD 10 trillion world-wide (i.e. the equivalent of US or European GDP), are among the largest institutional investors in the developed economies. These guidelines suggest that directors of defined-benefit pension funds be held legally responsible for protecting the interests of plan members and beneficiaries. Improved transparency and clearer communication between pension fund directors and pension plan members and an enhanced role for actuaries and auditors, when rules are broken, top the recommendations. These analyses and recommendations are consistent with the proposals contained in the Myners report[4], which blew the whistle in 2001, criticising some of the UK's biggest defined-benefits providers for management and governance irregularities.

FROM DEFINED BENEFITS TO DEFINED CONTRIBUTIONS:
SAVERS WHO BEAR FINANCIAL RISK DIRECTLY

In France, as in other Continental European countries – apart from the Netherlands[5] – the pension system is predominantly a mixture of basic schemes and, in some countries, points-based complementary systems, both of which are "pay-as-you-go" systems. While pay-as-you-go is the historical norm, it is facing serious problems in developed countries (and probably in emerging countries such as China in the medium term), particularly in terms of the demographic balance, resulting in shrinking returns and increasing contributions. It is probably also suffering from an absence of financial reserve building during the years of demographic and economic growth. The recent creation of government reserve funds in some countries (Canada, Ireland, Norway and France with the French Pension Reserve Fund (FFR)) is undoubtedly an interesting response, even though some of these reserves are still underfunded.

However, demographic trends are not the only factor causing problems for a purely pay-as-you-go system. The globalisation of economies has certainly played a part, particularly by making the framework of national economies too narrow. Thus, because of increased labour mobility and international competition, jobs are no longer as permanent as they were a few decades ago. Since wage trends are no longer determined by a single company and even less by the development of a single economy, firms can no longer single-handedly finance pension liabilities accumulated over an employee's lifetime. Stalling population growth and the changing labour market have led to the creation of defined-contribution policies that rely directly on individual responsibility, at least for a part of the replacement income on top of that financed on a pay-as-you-go basis. In most instances, however, firms have an incentive (generally via a tax benefit) to contribute to the efforts of their employees with regular top-up contributions (401 K in the United States and the save-as-you-earn scheme followed by PERCO in France).

Thus, for several years, we have been witnessing a double paradigm shift in terms of the way pensions are financed: the expansion of funded schemes in addition to the pay-as-you-go system and the shift from a defined-benefit pension fund system to today's predominately defined-contribution system. In terms of funded plans, it is no longer companies or pension funds that carry the risk but households. However, Continental Europe seems to be lagging particularly far behind in this dual process since there are very few pension funds in the region, whereas in the United States they are already predominant. It is important to note that this situation does not only display drawbacks: by directly developing complementary defined-contribution systems, Continental Europe will spare itself the difficulties experienced by UK pension funds, the majority of which are defined-benefit plans, which have been experiencing a particularly difficult period over the past few years because of their aggregate liabilities.

The changeover from a defined-benefits system to a complementary defined-contributions system requires in particular a complete change in the process of risk allocation between the various players and therefore in the nature of governance (i.e. the supervision, control and management of retirement plans and pension funds). In the case of defined-benefit plans, control and supervision are essentially the task of a central system (government, institutions, etc), which in effect represents the general interest of savers. Pensions are set in advance by the employer or group of employees at the initiative of the pension savings plan. Benefits are independent of the amount of contributions paid and the return on assets used to pay for provisions. A distinction therefore exists between the retirement plan and the pension fund: the former defines the rights and obligations of the employer and the employees covered by the plan; the latter guarantees that the contractual commitments of the plan are met. In the case of defined contributions, however, the contributions alone are fixed, since the level of pension payments depends on the return on the assets that make up the fund, and the plan corresponds exactly to the "fund" (Lavigne, 1998). *Ex ante* governance measures at the micro- and mesoeconomic levels are therefore essential in order to protect isolated and "non-represented" investors.

In terms of exposure to financial risk, these two regimes are fundamentally different. In second-pillar defined-benefit schemes in particular, risk is shared between employer and employee. The employer undertakes to top up the fund in order to maintain actuarial neutrality, while employees must balance current earnings (income from work and savings, social welfare payments, etc) and future annuities based on expected returns from the invested sums. Conversely, under defined-contribution regimes, by contrast, financial risk is assumed entirely by employees. In return, they do not lose a portion of their returns due to charges required by risk bearers to finance their capital, and they may more easily adapt their investments to fit their personal needs.

TOWARDS AN INVESTMENT MANAGEMENT MODEL SUITED TO LONG-TERM PENSION FUNDING AND THE NEED TO PROTECT THE FINANCIAL WEALTH OF HOUSEHOLDS

Fund managers are to some extent "risk conveyors", whose role is to diversify and distribute financial risk on the basis of the nature, importance and horizon of liabilities that need to be hedged. As such, they must be equipped to offer investors – whether individual or institutional – investment structures that suit their income needs over an estimated period and that are appropriate to their level of risk tolerance. Several issues need to be tackled in order to deliver this sort of management: the regulation model, governance and the quality of investment products.

It seems to us that the transition from defined-benefit schemes to defined-contribution schemes, i.e. from a collective system to an individual framework, involves different regulation models. Paradoxically, given their relative backwardness in terms of long-term retirement savings, it appears to us that the Continental European markets have a significant advantage over part of the Anglo-American world in terms of regulation.

There is no question that the Anglo-American model has always felt more at ease with institutional regulation. This is a logical consequence of the predominance of large defined-benefit funds that implement a “club” approach in which risk bearers are generally “sophisticated investors”. Consequently, and without wishing to be controversial, many UK and US institutional investors have always felt uncomfortable about adapting to the mass retail market given that the predominant culture is one of brokerage or recourse to independent financial advisors (IFAs). The major malfunctions experienced a few years ago with misselling in the United Kingdom and, more recently, the late trading, market timing and directed brokerage[6] scandals in the United States have highlighted this clearly.

Conversely, in Continental Europe, the retail approach, admittedly with the heavy banking and insurance regulation entailed, seems better suited to individual products insofar as it provides greater security for end investors. This focus on security for investors is partly due to the express desire of the major retail networks to preserve their reputation with customers, who have access to a full range of financial services from various financial institutions.

Regulation procedures are therefore significant for defined-contribution schemes.

As to the governance of players and products, the regulation of fund management, particularly UCITS is extremely strict. Virtually no other investment product offers such a high level of transparency and a wealth of information: daily NAVs, continuous comparative performances, regular publication of underlying portfolios and information concerning fees, etc. Since they are also covered by relatively homogenous regulation on a world-wide level, with national and European regulators such as CESR and international regulators such as IOSCO, investment funds are perhaps the first quasi-universal savings product. As such they are able to offer the security and mobility that multinational firms seek for their employees. In this respect, French asset managers are currently recommending the introduction of a complementary company-based European pension fund product, along the lines of 401K in the USA (while prohibiting the employee from investing significantly in the shares of his or her own company in order to prevent an excessive concentration of risk) or the collective retirement investment plan (PERCO) that was recently introduced in France.

Another key issue is the quality of financial management of products and the management of asset allocation over extended investment horizons. This is a major issue because it puts investors in direct charge of financial disintermediation and drives investment management professionals to design new products that meet investor requirements in terms of duration, diversification of country risk and asset classes as well as adaptation to increasingly complex financial markets. The result of this process is in fact a new offering, in which the management of risk and performance is tailored to the specific features of investor demand. In this area, French investment professionals' traditional liking for structured products and emphasis on modelling enables fairly spontaneous asset/liability management. Moreover, the long-term nature of the proposed investments is likely to encourage investors to pick products based on the intrinsic quality of the underlying assets. The emphasis on corporate governance and issues related to sustainable development and socially responsible investment (SRI) – areas in which Paris is a leading European financial centre, is one of the driving forces behind this trend. The highly constructive work done by investment professional in this area in conjunction with trade unions and SRI specialized rating agencies has relied heavily on the recent reorganisation of save-as-you-earn schemes.

IN ORDER FOR HOUSEHOLD SAVINGS TO BE FULLY EFFECTIVE AS A VEHICLE FOR THE LONG-TERM TRANSFER OF PURCHASING POWER, THE STATE MUST REMAIN NEUTRAL REGARDING INVESTOR CHOICE

The developments referred to above require that the state adopt a much more stable and less interventionist stance towards the level and allocation of household savings, particularly in terms of tax and regulation.

One belief currently in favour is that in order to revive growth and consumption the savings rate needs to be brought down. In the short term, and from a Keynesian perspective, this idea is appealing, because every year, through a mechanical effect, the non-saved portion of household income would be used for personal consumption expenditure and would therefore underpin economic growth. Over the medium- and long-term, however, this idea is rather dangerous, not only because it could produce unfavourable macroeconomic effects by dampening investment further down the line but also because it tends to obscure the microeconomic nature of saving, whose primary purpose is the accumulation of assets or of funds that help smooth consumption over the individual's life cycle. Note that while this microeconomic approach to saving is centred on the satisfaction of individual needs and interests it does not in any way preclude the idea that, through a pass-through effect, saving is the oil that keeps the engines of growth running (Brender, 2004). On the contrary, it is the sine qua non of growth.

Furthermore, French households have long been deprived of long-term savings vehicles designed for pension funding (life insurance alone serves as a partial palliative thanks to the medium-term freeze on withdrawals). While the government finally "filled the gaps" in the financial services industry in 2004 by creating the PERP (popular retirement savings plan) and the PERCO – France's first real complementary defined-contribution retirement products (one individual, the other collective) – it is extremely unfortunate that measures to stimulate consumption by unfreezing a portion of employee savings should have borne out concerns about the government's "activist" impulses regarding savings. The same is true, at the time of writing, of government temptations to unfreeze the annual "profit-share" of employees who are lucky enough to be offered such benefits by their company. The fact that, for many, this form of investment constitutes their only step towards long-term saving makes this measure all the more harmful. All these measures aimed at savings in order to give a temporary boost to the economy not only have a weak and short-lived effect in stimulating consumption, but, more importantly, help to further disorientate households that are already concerned about the economic consequences of the ageing population.

Lastly, contrary to current practice, the government must refrain from promoting a particular product to household investors, usually under the pretext of targeted financing of projects related to its economic policy objectives. The current structure of French household savings highlights an obvious bias towards short- and medium-term products. The relative scarcity of long-term, high-risk products offering higher returns, despite the growing need for finance at the end of the life cycle, shows that household choices are based less on investment horizon and risk aversion than on tax incentives that are far from neutral. As O. Garnier (2004) notes, if the protection and incentives offered by the welfare state were credible, households should, on the contrary, take more risk in terms of investment. This produces what he quite aptly calls the « inefficient investment of savings in France » phenomenon.

THE APPROPRIATE USE OF HOUSEHOLD SAVINGS:
A CHALLENGE FOR ASSET MANAGERS; A CHALLENGE FOR POLITICIANS

Asset management companies have a fundamental role to play regarding the growing transfer of risk to the household sector. The products on offer must not only ensure sound protection of existing wealth but must also offer savers the tools to make investment decisions that enable them to optimise the income from their savings. Apart from reinforcing the governance of managers and improving the financial education of various beneficiaries, this process demands greater coherence on the part of government, particularly in terms of applying a relatively neutral and stable fiscal and therefore savings policy. However, let us not forget the basic idea that, beyond vital needs, consumption depends primarily on the public's confidence in their future. Whatever happens, any stop-and-go political intervention in this key structural area – savings - often threatens to undermine the confidence of consumer-savers.

NOTES

[1] The third-pillar retirement savings product 401 (K) is a company-administered personal vehicle that allows matching contributions from the employer, while the IRA (Individual Retirement Account) is, as its name suggests, a strictly personal product that does not receive complementary contributions.

[2] Price formation occurs through the transparency of options, which usually remain hidden and therefore unvalued under an intermediated finance system.

[3] Report entitled "*Pour l'éducation économique et financière des épargnants*" ("The economic and financial education of savers") written by a cross-market working group initiated by the AMF in May 2005.

[4] Report written by Paul Myners at the request of the Chancellor of the Exchequer Gordon Brown, with the aim of assessing the possible explanations for the investment policy and especially the performance of UK pension funds (www.hm-treasury.gov.uk/docs/2001/myners_report0602.html).

[5] Like the Anglo-American model, Dutch pensions are based on a three-pillar system: a basic pay-as-you-go regime involving small sums since they cannot exceed a certain percentage of the legal minimum wage (first pillar), complementary, company-administered funded system (second pillar) and personal pension funds (third pillar).

[6] Incentive whereby a distributor is rewarded for selling a particular investment fund by the volume of securities orders directed to the affiliated brokerage firm.

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