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Thematic paper | CROSS ASSET Investment Strategy

July 2018

Pacte Law :
What changes lie ahead for savings in France?

Research & Macro Strategy

Pacte Law: What changes lie ahead for savings in France?


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Finalised on 18/06/2018

The essential

The Pacte Law[1], presented on June 18, 2018 at the French Council of Ministers, should come into force no later than January 2020, after a period of parliamentary debates and the publication of implementing decrees. Several aspects of the law concern French savings. Their goal is to finance the French economy in a more efficient way, by offering to associate more employees with the benefits of economic growth (especially in SMEs) and by encouraging savings and investment. We decode the 5 key proposals of the draft law, regarding the development of profit sharing mechanisms within the firm, the generalization of life-cycle investment strategies, and the flexibility in exit requirements for accumulated savings at retirement.

Key goals and proposals of the new Pacte Law

The Pacte Law's goals are to **finance the French economy more effectively**, **do a better job of ensuring that employees share in the benefits of growth,** and **encourage French people to save and invest**, particularly with a view to supplementing their pensions.

The new legislation will have major implications for retirement savings and is expected to:

1. **Promote retirement savings within small businesses** by scrapping the *forfait social* (a contribution paid by employers and levied on compensation or gains that are not subject to social security charges and contributions) for incentive plans at companies with fewer than 250 employees and for profit sharing plans at companies with fewer than 50 employees.
2. Promote **employee share ownership** by relaxing the procedures used by simplified joint-stock companies to offer shares to their own employees, by allowing employers to contribute unilaterally to employee share ownership funds and by halving the *forfait social* for employer contributions to such funds.
3. Make **retirement savings more appealing by allowing *people to take their savings with them*** when they change employer and by harmonising investment vehicles (*Article 83, PERP, Madelin, Perco*), including in terms of tax treatment for payments.
4. **Relax exit requirements** at retirement: the requirement to take out an annuity will be restricted to products subject to mandatory payments, early withdrawals will be possible, notably to buy a primary residence, and all annuity policies will include the option of paying survivor benefits to a spouse.

[1] *https://www.economie.gouv.fr/plan-entreprises-pacte*
Pacte for Plan d'action pour la croissance et la transformation des entreprises

5. Encourage **life-cycle strategies**, which are to become the default option for all supplementary retirement saving schemes. This will give people an incentive to put their money in riskier and thus potentially higher-earning investment products invested in the real economy.

Refocusing savings products around the needs of retail investors

1. Encourage long-term, diversified savings

The natural objective of long-term savings is, at the very least, to **protect accumulated capital against erosion from inflation**, while potentially generating a supplementary return over inflation. While this may seem like a simple goal, it is not so easily achieved over the long run, particularly in the current low interest rate environment, which is starkly different from the one we have known for the last 40 years.

Long-term financial management is based on a few simple principles:

- **Positive rewards for risk taking** mean that retirement savings cannot be entirely placed in risk-free investments. Even highly risk-averse people must invest at least a small portion of their portfolio in risky assets to benefit from the increased returns
- A **money market investment is risk-free only in the short term**. A strategy based on rolling over a money market investment year after year is not risk-free in the long term because interest rates fluctuate over time and protect capital only partially against inflation
- A long-term investment has to be **diversified** in bonds (ideally inflation-linked) and higher-risk investments such as equities and real estate. The benefits of diversification are substantial and can **drastically lower a portfolio's risk of capital loss**. For example, a portfolio that is 50% invested in equities and 50% in bonds will halve its risk compared with a portfolio that is entirely invested in either equities or bonds

> "The benefits of diversification are substantial and can drastically lower a portfolio's risk of capital loss."

2. Why promoting life-cycle funds ("gestion pilotée") as the default solution?

A simple and diversifying strategy...

Life-cycle investment is a simple, **diversified investment strategy that factors in the saver's investment horizon**. When retirement is still a long way off, savings are heavily invested in equities. They are then gradually rebalanced to include lower-risk investment vehicles, such as bond and money market funds, as the saver grows older. This approach was adopted as the default solution for group retirement savings plans (Perco) in 2015 and is expected to be introduced across-the-board for all investment vehicles.

...that takes account of each person's human capital

Life-cycle investment has its roots in academic research (notably by Paul Samuelson and Robert Merton, who won the Nobel Prize for Economics), which shows that people need to consider their **human capital** when taking investment decisions. Human capital is the present value of wages paid throughout a person's working life and makes up the bulk of an individual's capital when he or she starts working. Human capital shrinks over time, gradually replaced by the financial capital that the individual manages to accumulate. When low-risk, human capital can be treated like a bond portfolio. Accordingly, **to obtain a stable diversification profile over time**, individuals should invest a large proportion of their financial capital **in equities when they are young** and then gradually **scale back risky investments as they grow older**.

> "When low-risk, human capital can be treated like a bond portfolio."

A solution that can be easily tailored to individual needs

This simple strategy, which matches the needs of a default investment solution, can of course be **adapted to market conditions** and **tailored** to suit the desired decumulation strategy at retirement, risk aversion and human capital risk profile, which depend on the person's sector of activity, job situation and other factors.

Consistent with international regulatory developments

Widespread adoption of life-cycle strategies as a default solution is also a regulatory development **consistent with steps taken in other countries**. The USA's 2006 Pension Protection Act, for example, established these types of fund as a qualified default investment alternative (QDIA). In Europe, the introduction of life-cycle strategies as the default investment solution within the Pan European Pension Product (PEPP) framework is also being discussed.

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3. Why greater flexibility in exit requirements for accumulated savings at retirement?

Current situation: possible decumulation strategies at retirement

In France, **there are currently two options**: investors can (1) convert their capital into a **fixed annuity**, or (2) **decumulate it on their own or using scheduled withdrawal strategies**. Each solution has its advantages and disadvantages, but taken in isolation, neither one is perfectly suited in terms of an individual supplemental retirement savings solution.

Annuity

The **main advantage of an annuity** is that it gives individuals an opportunity to insure against the risk of longevity and benefit from "mortality credit" (a gain related to the fact that the funds contributed by individuals who die younger are shared with those who live longer). However, life annuities guaranteeing a fixed income are currently **very expensive** due to extremely low interest rates and oblige the insurer selling them to invest the corresponding capital in low-risk assets which are therefore not very profitable, to offer the guarantee. In addition, fixed annuities (offering nominal guaranteed income) **do not offer any protection against inflation** or allow individuals who wish to do so to continue investing in risky assets to achieve a potentially higher benefit level. Finally, a life annuity is **irreversible**. In its simplest form, it precludes the ability to hand down capital to one's heirs or collect capital if cash is needed due to unexpected expenses.

Scheduled decumulation

Individuals often prefer **scheduled decumulation** strategies through which they select a withdrawal formula for their funds for their entire retirement (such as a fixed % of the capital every year, or a variable % of the capital according to remaining life expectancy). These solutions allow them to **continue to invest in risky assets** and **bequeath money**. But in this case, the individual runs the risk of **exhausting their capital before their death**.

Little appetite among individuals in life annuities

In Australia, people have three choices. Nearly 50% choose to collect their capital, and 50% choose scheduled payments, which allow them to maintain exposure to risky assets. A very small minority chooses to purchase the annuity (less than 1%). In the United Kingdom, the 2014-2015 reform (Pension Freedom) eliminated mandatory annuitisation and caused the total value of contracts sold to fall dramatically in favour of scheduled retirement strategies.

When Amundi and Natixis AM surveyed customers regarding their opinion on the Perco change (131,000 customers from both institutions were surveyed), 48% of them indicated that they wanted to continue to let their capital grow after retirement, 20% wanted to convert it into a fixed annuity at retirement and 15% wanted to collect their capital and dispose of it as they wished. These figures reflect the **diversity of individuals' situations and needs.**

The benefits of flexibility

The best retirement solution **uses 2 types of products: annuities and investment solutions**. The theoretical work on this subject recommends a **gradual annuitisation** strategy through which the individual keeps their capital invested in risky assets for a long time after retirement in order to continue benefiting from the associated risk premium (and therefore the additional yield). The other advantage of gradual annuitisation is that it does not force individuals to take the irreversible decision to convert all of their assets into an annuity on the day of their retirement (or even in some cases well before).

Flexibility also allows us to **tailor the annuity-conversion strategy to market conditions** and in particular to temporarily stop annuity conversions when the rates are very low and the annuities are particularly costly, as is the case currently. We are living longer, and retirements are getting longer as well. In this context, combined with exceptionally low interest rates, the retirement phase must be conceived of as an **active investment phase** during which we can continue engaging in projects during retirement, while progressively providing for our essential consumption needs at the end of our lives.

Flexibility can also **encourage more saving**. Academic research looking at 401k plans[2] in the United States has suggested that the ability to access one's funds before retirement (in the form of withdrawals or a loan) has a significant impact on the propensity to save money, increasing the contribution rate by 1%.

By being able to freely choose an exit method for all retirement savings products, and even to mix and match the two product types, individuals will be able to **choose the solution that best suits their situation** in terms of their basic and supplemental retirement coverage, accumulated capital, liquidity needs, family situation (couples have less need for longevity protection than single people, for example), consumption requirements, desire to leave money to someone, and so on.

4. Give employees a stake in their company's performance by doing a better job of sharing profits and growth

Profit sharing schemes strengthen social cohesion within a company

Employee savings schemes are a simple way to **give employees a stake in the performance of their company**, either through incentive and profit sharing payments or by setting up an employee share ownership plan, which are schemes promoted in the bill. Currently in France, **just 16% of employees in companies with fewer than 50 employees** are covered by an incentive or profit sharing scheme. The law aims to double this percentage.

Profit sharing mechanisms (incentive plans, profit sharing plans, investment in company shares) are often considered to be a form of **economic democracy, helping to reduce conflict between employees and employers** and improve social cohesion and equality by sharing the company's earnings more broadly and more fairly. Some studies have shown that employees are more committed to and identify more strongly with their company when they are shareholders. According to academic research, the impact on job satisfaction, employee motivation and company productivity is not uniform, but on average, employee share ownership is associated with company performance and **productivity gains in the region of 4% to 5%**.

> "Some studies have shown that employees are more committed to and identify more strongly with their company when they are shareholders."

An important scheme for small companies

Today, incentive plans and employee share ownership schemes are primarily used by large firms. Yet in theory, **productivity gains should be even bigger at smaller companies**, where the individual incentives to engage are greater if profits are shared among a smaller number of employees. Accordingly, there is every reason to suppose that promoting these profit sharing approaches within smaller companies could well improve the competitiveness of French businesses.

Employee share ownership: a source of capital stability

For companies, having employees own shares is also a **source of capital stability**. In many circumstances, managers and employees team up against hostile takeover bids, significantly lessening their chances of success. In the USA, numerous companies set up employee stock ownership plans (ESOPs) at the end of the 1980s to protect themselves against takeovers.

[2] *A 401(k) plan is an employer-sponsored retirement savings system used in the United States.*

NOTES

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