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In this introduction, I would like to address two rather different sets of issues. First, a broad overview of the state of pension reform in France. The French pension system is a rather complicated one, the reform process itself follows a tortuous route, and an assessment of the current state of the pension system in one of the largest euro economies might be useful. Second, I would like to enlarge upon some concerns I have regarding the way pension money is managed, not only in France but in other countries as well. Indeed, while I fully support the current move towards increased funding for French pension schemes, I must confess that I am worried by the rising risks posed by what I see as inappropriate investment guidelines.

The current state of French pension reforms

The (convoluted) French pension system has three main characteristics:

- First, it is a very fragmented system with many different regimes, more than 20, and different rules depending on the worker's status.
- Second, the normal retirement age is still 60 in most cases (except for special groups of public-sector workers, such as railway workers, who can take early retirement with full benefits).
- Third, the system is mainly on a pay-as-you-go basis. Most employees entitled to full pensions still receive, from the basic and complementary regimes, around 80% of their last salaries upon retirement. Such a high replacement ratio leaves little room for «pension funds» or other forms of retirement savings. In the private sector, contributions to the pay-as-you-go system already amount to more than 30% of net wages.

This "generous" and fragmented pay-as-you-go system needs to be reformed, to cope with the doubling of the number of individuals above 60 in the next 40 years. France is often considered to be the European laggard concerning pension reform. However, the truth is that significant reforms were decided in 1993 and 1996 for the private sector schemes, and their implementation has begun. The real French specificity lies in the complete standstill in pension schemes covering public sector employees.

As a result of those reforms, the replacement ratio at the age of 60 in the private sector is expected to fall significantly in the future, from around 80% currently to

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60% or less in 2040 (even for those who started to work early and have the required 40 years of contribution). The attempt to implement similar reforms in public sector schemes failed in 1995, after causing some impressive strikes and ultimately the demise of the government.

While underestimating the reforms already decided upon in the private sector, many foreign observers criticize France for its failure to set up "pension funds". This is a rather debatable criticism, since the equivalent of defined-contribution pension funds has existed for decades in France. France has created strong tax incentives for life-insurance contracts and other long-term savings, which already attract the bulk of French household saving. In particular, there is a form of savings plan, the PEE (Plan d'Epargne d'Entreprise), which shares many similarities with the popular US 401(k) savings plans. That is a vehicle for workers to acquire mutual funds. Such plans require agreement between the workers' representatives, the company and a fund manager, and they benefit from various tax-breaks. Recently, the Jospin government has significantly increased those tax incentives for plans with a long-term horizon. Various measures have also been taken to facilitate access to such schemes for small and medium-sized enterprises.

In fact, the French specificity is definitely not the lack of "pension funds", but the lack of incentive to save, owing to the high replacement ratio expected of the pays-as-you-go system. The 1993 and 1996 reforms in the private sector have already started to change this situation.

Overall, France is pursuing a strategy of its own, but still has a lot to do in order to improve the sustainability of its pension system, especially in the public sector. These reforms will certainly have to wait until after the 2002 general elections. However, and it seems that some foreign observers have partly missed this point, as in most countries, the trend is definitely towards more pension saving in a defined-contribution setting.

Financial risks of a funded pension system

Overall, I am happy with these developments, and I am only concerned that the debate in France is sometimes too ideological, with certain participants in the public sector refusing even to acknowledge the looming deterioration on the demographic front. That being said, I am equally concerned that while many economists have been very vocal advocates of fully-funded pension systems, they have spent very little time trying to think about the financial risks and implications of funded pension schemes.

The funding of pensions creates a sizeable amount of financial risks. Asset prices may vary sharply, and someone has to bear those risks. Risks can be shared, transformed or transferred, but they never disappear, even with the help of the most creative of accountants.

It is of the utmost importance that the incompressible and large financial risks involved in the funding of pensions are borne by people who understand them, and are able to endure the vagaries of financial markets. That is not always the case, particularly in countries with less developed financial markets.

For OECD countries, I have two specific worries.

1. Firstly, I can't help being surprised by the rather unsophisticated methods used by most long-term investors, be they households or professionals, when they assess the risk-return tradeoff of their investment strategy. I am happy to see that a recent report in the UK, the Myners report, has expressed similar concerns. More often than not, asset allocations are based on rigid benchmarks. Those benchmarks generally do not result from an in-depth analysis of current valuations and their implications for future returns, but rather from a simple extrapolation of past returns, leading to excessively rigid risk-return assessments. As a result, for example, the estimated risk premium for equities becomes fairly independent of market valuation. In short, the share of equities was similar, with Nasdaq at 5000 or at 2000! It seems hard to dispute that the demand for equities should be more sensitive to key valuation indicators, like the market price-earnings ratio or the value-to-book ratio.

   For the time being, this rigidity provides a fillip to the equity market, as benchmarks are based on the assumption that future returns will look much like those in the past. But, this naive faith would be shattered by a long period of underperformance. This backward-looking methodology obviously leads to a situation where investors are overexposed at the peak of the cycle and underexposed at its bottom. This is clearly detrimental to the performance of those investors. More importantly, **financial stability will be at risk as long as asset allocations are based on the extrapolation of the past, rather than on a fundamental analysis of current valuations.**

2. Secondly, I am also worried by the lack of transparency and robustness of some risk-sharing arrangements in financial markets. Some institutions claim that they can shield workers and pensioners from most, if not all, of the financial risks involved by the funding of pensions. These institutions can be either traditional defined-benefit pension funds or, in some countries, life-insurance companies, which provide various forms of guarantees on long-term saving. It is very hard to assess whether such institutions have the financial clout to fulfil their commitments in all sorts of market environments, and I do not think the regulatory framework is protective enough for the policy-holders. In particular, it is well-known that there are loopholes in the regulation of life-insurance companies in some countries, and not only in Japan. This worry is exacerbated for defined-benefit pension funds sponsored by private companies. These are indeed very unusual financial institutions, which seem endowed with the quasi-magical ability to make financial risk disappear! Indeed, workers

assume that pension promises will be fulfiled whatever happens in the stock market. At the same time, financial analysts and shareholders looking at companies' valuations don't really care about the pension-fund situation as long as there is a large surplus in the fund. In other words, as long as the market value of assets exceeds the pension liabilities, neither workers, pensioners nor shareholders show much interest in the pension fund's financial situation. But let's repeat that financial risks seldom disappear. Indeed, in my view, shareholders and the financial analysts working on their behalf considerably underestimate the financial risk involved in the business of providing defined-benefit pensions. And this is true even of companies with well-funded pension funds. Pension fund surpluses, when they exist, are a key asset for companies as they warrant investment in riskier financial instruments. Benefiting from higher returns, they may provide pensions at a lower cost. This puts these companies in a comfortable position relative to their competitors, which have to pay high contributions to pay-as-you-go public regimes. But the opposite holds when the pension-fund surplus falls owing to adverse market conditions: this competitive advantage declines sharply as well. **Like it or not, financial risk does not disappear, and the ups-and-downs in pension-funds surpluses directly affect the true, fundamental value of the sponsoring companies.**

This analysis has various interesting implications. I will briefly mention three of them. I hope that we will have an opportunity to discuss these issues further during the course of the panel discussion.

- First, a bear stock market could send a wake-up call to financial analysts and shareholders investing in companies with large defined-benefit pension funds. As long as fund surpluses are high and the resulting costs of pensions are low, they are unlikely to improve the way they value the pension obligations of the companies. But a falling surplus would put under scrutiny the pension funds' situation, and the risks involved in providing defined-benefit pensions.

- Second, it is rather difficult to form an opinion on the changes in investment strategies that such a combination of bear market and falling surplus could trigger. On the one hand, if shareholders have a better understanding of the risk they are exposed to, they may ask for more conservative investment policies, and as a result, contribute to a downturn in the financial markets. On the other hand, there is a kind of "moral hazard" at work, and the funds' sponsors may gamble that they will be able, if their risky investment strategies were to fail, to renege on some of their pension promises and thus to share the losses with the workers.

- Third, defined-benefit pension funds deserve a specific set of regulations. There is a widespread view that pension funds are absolutely right to invest in risky assets since, in the long term, these investments provide higher returns. But I really do not think that a pension fund is the right place for a corporation

and its shareholders to locate the risks they wish to bear in order to boost expected returns. There are more efficient and more transparent ways of taking risks. In general terms, it is a better choice to locate leveraged positions in a corporation's main balance sheet, rather than partially hidden in the pension fund. Therefore, I am very sympathetic to the principle of stringent regulations severely limiting the mismatches between pension-fund assets and liabilities.