‘The Future of Savings’ Conference
Business models and regulatory changes in the new environment

Session « A view from Europe »

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# Real returns during the XXth century

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Destiny of French bondholders in the XXth century

Annualized real return of French bonds for a 20-year holding period finishing in December...
Destiny of French stockholders in the XXth century

Annualized real return of French equities for a 20-year holding period finishing in December...
Summary

- Financial reserves of French life-insurers: 1 500 billion euros.

- Most households with life insurance have a long-term objective. But insurers have invested their savings mostly in short-lived, safe and liquid assets.

- This is inefficient, both for savers and for the economy.

- This market failure originates from an inefficient product design (initially constructed under a very inefficient solvency regulation), and from an inappropriate incentive mechanism for long-term saving.
The golden age of assurance-vie in France

- Characteristics of the « euro contract »:
  - partial intergenerational mutualization;
  - a minimum guaranteed return (now 0%);
  - maximum liquidity;
  - tax incentive for contracts older than 8 years.

- In a context of diminishing returns, insurers have served the large return of the past investments to new customers. 😊

- In the future, insurers will serve the low return of the current investment to new customers. 😞 There will be the real test…
The golden age of life insurance in France

Figure 1: Evolution of reserve. Source: Cours des Comptes (2012)
Interest rate and the return of assurance-vie in France

Source: FFSA.
Intergenerational risk-sharing (IRS)

- Heterogeneous destiny of generations of savers.
- Market failure: Markets cannot organize risk sharing with future generations of savers (Diamond (1972)).
- By mutualizing financial shocks across generations, life insurers and pension funds could partially cure the failure. But this requires a public intervention to reduce savers’ opportunistic behavior: tax advantage.
- Gollier (2008): Potential benefit of intergenerational risk-sharing equivalent to raising the annual return of saving by 1%.
- The current assurance-vie system is a second-best:
  - The incentive is too small and the contract is too liquid, thereby forcing insurers to limit IRS.

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Long-term savers are in a better position to smooth short-term financial shocks on their wealth by small changes in consumption over a long period.

There is some mean-reversion in equity returns. Equity is relatively less risky for longer holding periods.

These two effects make long-term savers less risk-averse. It is socially desirable that they bear a larger fraction of the macro risk.

Intergenerational risk-sharing organized by life insurers and pension funds should induce them to take more risk.

On the contrary, French life insurers are now massively invested in bonds (mean maturity around 6 years).
USA: Campbell-Viceira (2002)
Liquidity of assurance-vie

- Although most households with an assurance-vie contract are long-termists, the euro contract is very liquid.

- Therefore, estimating the maturity of life insurers’ liability is France is a complex matter.
  - They potentially face an insurance run in case of an abrupt increase in interest rates.

- Moreover, there is a ratchet effect coming from the rule that returns are offered on an annual basis rather than at the termination date.

- The extreme liquidity, the guaranteed return and the ratchet effect forced French insurers to invest in safe, liquid assets, in particular when the interest rate converge toward the guaranteed return.
  - It’s not SII fault! It’s the fault of the characteristics of the euro product;
  - The inability of SII to produce an “intergenerational risk analysis” framework is a second-order problem.
To whom should we offer portfolio insurance?

- We cannot have the cake and eat it. Combining the ratcheted guarantee, the large return and the liquidity is impossible.
  - When one guarantees a 0% return and interest rate=0%, one should take zero risk…

- Someone must bear the macroeconomic risk. We cannot provide portfolio insurance to 100% of the population.
  - It makes little sense to offer it to the wealthiest fraction of the population.

- SII will force French insurers to reconsider this triplets of characteristics. The premium associated to the guarantee (portfolio insurance) will have to be better/actuarially priced.
  - At equilibrium, only a minority fringe of the population should purchase the insurance (Leland (1980));
  - As long as this problem is not fixed, it will not be possible to create a market for more efficient contracts (« eurocroissance »?).
Recommendations

- A market for long-term saving remains to be created in France.

- A revised SII regulation that better recognizes the creation of value of life insurers as providers of intergenerational risk-sharing should be proposed.

- This regulation should induce insurers to price their contractual guarantees in an actuarially fair way. This will reduce the attractiveness of the euro contract.
  - As long as this is not done, other initiatives are doomed to fail.

- The market will then be in a better position to create efficient LT saving products, conditional with a stronger fiscal incentive to fight savers’ opportunistic behavior.

- Assurance-vie is a mass/vanilla product with a limited value creation from advising customers. Management costs/fees should be more compressed.