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Household savings in the euro area

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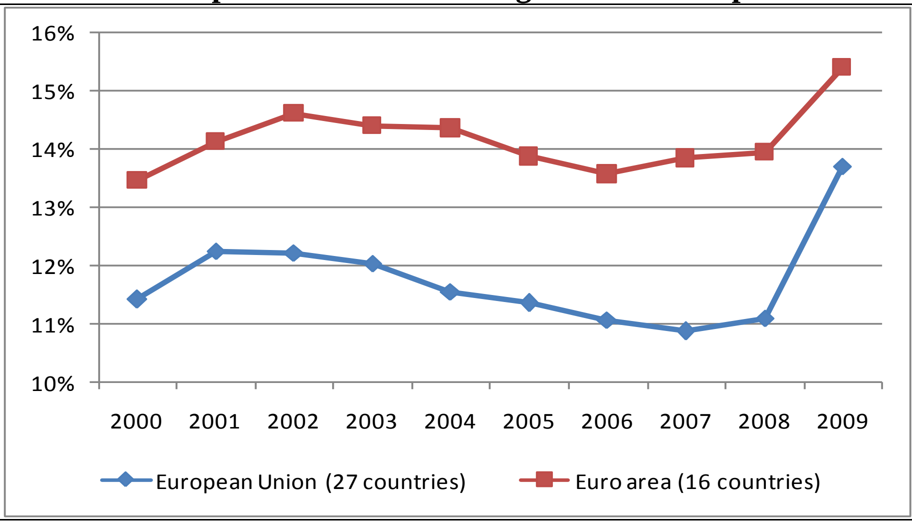
The euro area households save a lot, and they save more than they did in previous years: they spend on average nearly 16% of their income on savings. In this article, our objective is to identify the drivers of savings and the main components of investment flows. In the first section, we show that the recourse to credit is a key factor in explaining historical trends in savings ratios and its variations across countries or economic areas. The second section analyses how overall household financial wealth was hit by the financial crisis. The third section argues that the dominance of banks in savings products distribution explains the specific composition of financial savings in the euro area. Finally, a fourth section analyses how the euro area savers deal with issues related to a general trend in the world, namely the lengthening of life expectancy.

1. Loans make savings

The ratio of household savings to their gross disposable income in Europe shows two highlights (Graph 1):

- The ratio is permanently higher in the euro area than in the rest of Europe. Over the last ten years the average gap was 2.4%. Its minimum value was recorded in 2009 (1.7%).
- The ratio hit a highest in 2009, as it jumped from 14% in 2008 to 15.4%.

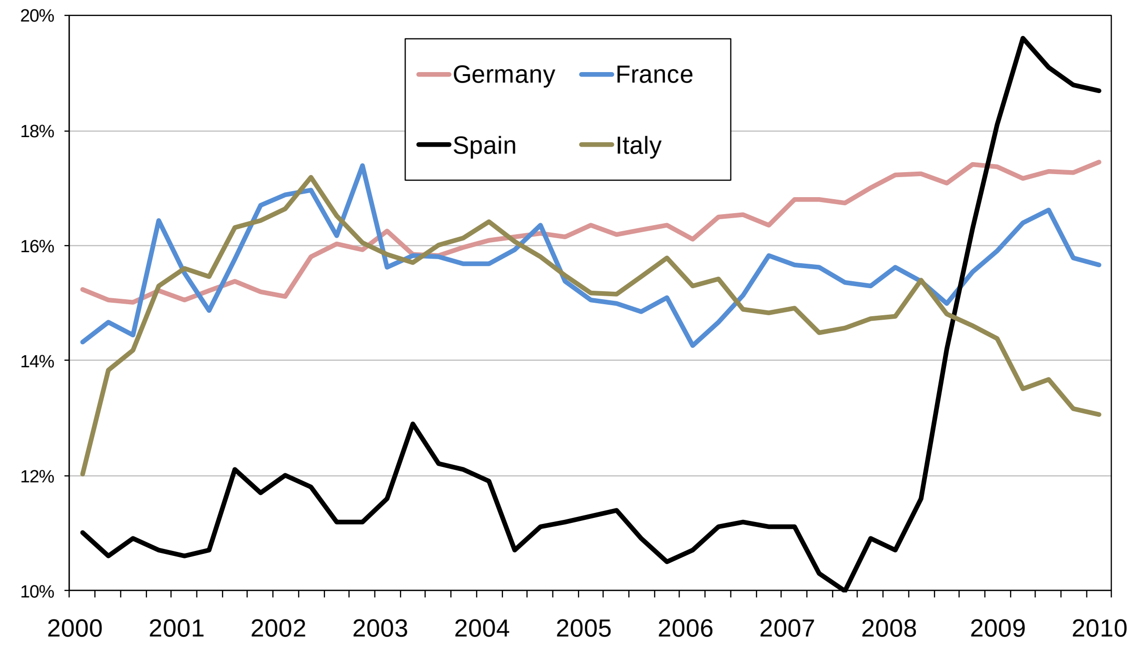
Graph 1: Household savings rates in Europe



Source: Eurostat

Whereas all countries showed similar savings rates in 2003, they diverged in the course of the last decade. In Germany, it regularly rose. It was more volatile in Italy and France. Spain shows specific trends: until the financial crisis, it was the country with the lowest savings rate among the euro area's largest countries. Spanish savings then rose in 2008 and they are now the highest in the euro area (18.7% of GDP at first quarter of 2010).

Graph 2: Savings ratio in euro area countries



Source: National accounts, OEE calculations

There are two methods of calculating savings: from the "real" national accounts, savings are what remain from the households Gross Disposable Income after deduction of all their consumption expenses. From financial national accounts, savings consists of financial investments and non-financial investments minus the increase in debt (savings is a flow, not a stock). Both calculations should result in identical figures, though in practice the use of different sources (consumption in the first case, flows of funds in the second) generates statistical gaps.

The second method can be presented as flows:

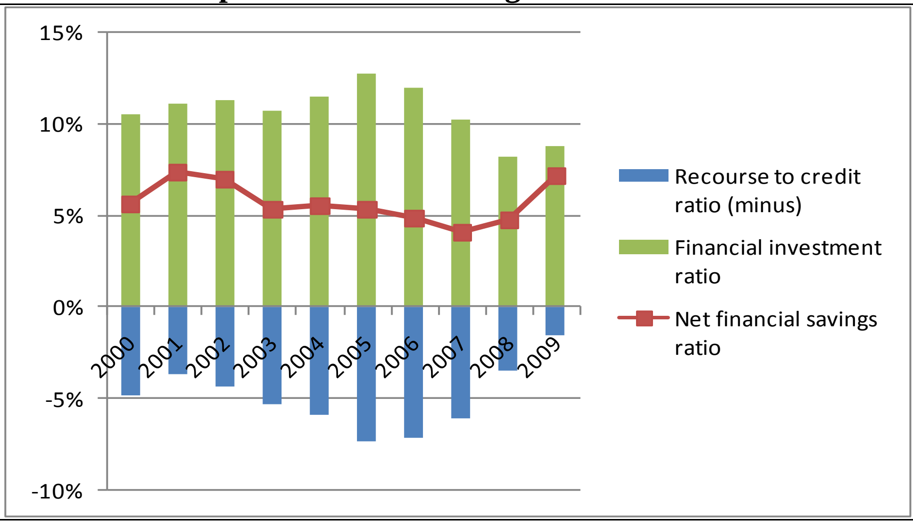
Savings rate = financial investment rate + non-financial investment rate – rate of recourse to credit

Where:

- The financial investment rate is the ratio of net financial investments (purchases minus sales) to the Gross Disposable income.
- The non-financial investment rate is the ratio of non-financial investments to Gross Disposable income. The main component of household non-financial investments relates to property. It also includes professional investment of individual entrepreneurs whose professional activity is not run within a specific legal entity.
- The rate of recourse to credit is the ratio of new credits minus reimbursements (the increase in debt outstanding) to Gross Disposable Income. It includes all kinds of debt. The main component is housing credit. Smaller components are consumption credit and professional credit.

Observation of these three ratios helps to understand the trends in savings rates.

Graph 3: Financial savings in the euro area



The inverse correlation between financial investments and recourse to credit is striking: both the recourse to credit and financial investments increased from 2003 to 2005 and then decreased until 2008: "Loans make savings". More specifically, the dynamics of household savings behaviour until the financial crisis can be described as follows: real estate prices soared, a trend that had two consequences. The net sellers of real estate assets benefited from significant capital gains, which were reinvested in financial assets. At the same time, net buyers of real estate assets had to take more money from their financial assets to offset the effects of price increases. However, the recourse to credit also contributed to offsetting real estate price increases, so that the inflow of financial assets by real estate buyers was superior to the decrease of financial assets held by net buyers. This context allowed households as a whole to be net buyers of financial products.

This mechanism faces long-term socio demographic trends in Europe. Life expectancy has increased. We are increasingly seeing heirs, often in their fifties, inherit familial property after they have acquired their own property themselves. They are aware of the fragility of pay-as-you go pension regimes. They also know that a longer life often goes with a risk of dependency, a risk that their children will not necessary be able to bear. Hence, they invest their capital gains on medium to long-term savings products, such as life insurance or individual retirement products.

The exceptionally high saving rate in 2009 can be explained by a dramatic decrease of recourse to credit, while precautionary savings increased due to the rise of unemployment and actual or anticipated tax increases.

2. The financial crisis: Household investments offset their assets' devaluation

European savers are currently confronted with a paradoxical economic environment:

- The financial crisis, rising unemployment and the downward pressure on their income incited them to increase their precautionary savings. Savings ratios reached historical highs in most countries.
- Meanwhile the returns of most financial assets decreased or were uncertain: Not only have short-term interest rates reached historically low levels, but so have government debt securities from countries without solvency problems. The increase observed on stock markets during the first quarter of 2010 stopped. No clear or homogenous trend is perceptible on real estate prices, which stayed high in most countries.

At the end of March 2010, total financial assets held by euro area households amounted to 17.448 billion Euros, i.e. 53 K€ per capita on average (Table 1). Households portfolios continued to grow slightly through the financial crisis, with a total wealth up by 4.6% at end of March 2010, compared to the end of 2006. But this increase is the result of two opposite trends: devaluation of assets decreased the value of portfolios by 15.9%, whereas investments flows increased by 20.4% the initial outstanding assets. In real terms, household investment efforts offset their capital devaluation. However, it should be noted that these capital devaluations are only virtual losses as long as assets are not sold. In particular, the greatest component of devaluations originates from non-listed shares, whose valuation by statisticians is a convention partly derived from the valuation of listed shares. Unit-linked life insurance contracts and defined contribution pension funds also generated unrealised losses (which represented 13% of total outstanding life insurance and pension funds at end of 2006), but steady subscriptions to this category of products more than offset the virtual losses.

Two categories of products of similar importance dominate the composition of euro area households overall portfolio: currency and short-term deposits plus life insurance and pension funds together account for 62%.

Shares and other equity are the next category of assets. Unfortunately, the breakdown of this asset class into quoted shares and non-quoted shares or other equity is not available in all countries. But the economic nature of a liquid quoted share in a portfolio is very different from the business personal equity held by individual entrepreneurs. Moreover, in the absence of an observable price, the evaluation of non-quoted equity is by nature a convention, and statistical treatments applied by the producers of national accounts probably diverge from one country to another. Nevertheless, it is clear from statistics in countries where quoted shares held are recorded separately that this asset class represents only a minor part of the overall portfolio of households. Privatisations may diffuse share ownership of quoted shares to a great number of individuals, but the amounts held by a majority of retail investors remain relatively low.

Finally, three categories of assets each represent less than 5% of financial assets held by households in the euro area: long-term deposits, debt securities and mutual fund shares. In some countries these asset classes are more important. For example, long-term deposits are relatively high in France, with the main component being the home-ownership savings plans ("Plans d'Epargne Logement"), which benefit from tax incentives and public subsidies. In Italy, households traditionally hold more bonds than in other countries because the Treasury has long been willing to sell its debt to domestic retail investors. But in both cases, these holdings tend to decrease in relative terms and to converge to standards observable in the rest of the euro area.

Mutual fund shares are a small component of household financial portfolios. But in many countries, individuals also hold mutual fund shares through "wrappers", such as life insurance contracts. There are no statistics at a European level of such indirect holdings of mutual shares, though they are, however, sufficiently significant to motivate a regulation by the European Commission that aims to harmonise their selling rules with similar underlying products[1].

Table 1: Breakdown of financial assets held by households in the euro area (end of March 2010)

	In K€ per capita	% of total financial assets	2010 Q1 /2006 Q4
Currency and short-term deposits	16.6	31.2%	+22.1%
Long-term deposits	3.0	5.7%	-2.8%
Debt securities	4.3	8.0%	+4.6%
Shares and other equity (other than mutual fund shares)	8.9	16.7%	-18.7%
Mutual fund shares	4.4	8.2%	-15.0%
Life insurance and pension fund reserves	16.1	30.2%	+ 14.4%
Total	53.4	100.0%	+4.6%

Source : ECB

3. The link between portfolio composition and savings products distribution

Naturally, the weight of banks in the distribution of savings products impacts asset allocation by households. Indeed, banks influence choices made by their clients by their marketing

[1] *Communication of 30 April 2009 on Packaged Retail Investment Products (PRIPs), European Commission [COM(2009) 204 final]*

campaigns, the incentives and objectives of financial advisors and by the structure of their offer, for example, inciting clients to hold a certain category of products in packages that also include basic payment services (credit card, cash account, overdrafts etc).

A striking feature of the retail market in the euro area is the overwhelming weight of banks in the distribution of savings products. In the past, banking products in the euro area were distributed by banks, and insurance products by insurance companies or insurance brokers. Securities played a minor role in the savings of “mass affluent” private investors and they were mainly sold by securities brokers to High Net Worth Individuals.

Things have changed. Firstly, banks have become increasingly involved in the production of insurance products, particularly life insurance contracts. They have become financial conglomerates with insurance branches producing life insurance products that are distributed by their retail network. For example, life insurance products became the biggest component of the financial portfolio of households in France, and “bancassurance” groups account for more than 70% in this segment of the market. The remaining 30% are still produced by pure insurance companies and they are distributed either by these companies’ employees, by tied agents or by insurance brokers who often sell the products of several competing insurance companies.

A second trend is the growing importance of private banking activities within the banks. Most retail banks tend to create specialized departments or specialized fully owned affiliates for servicing their richest clients. Hence, banks play a major role in the distribution of securities and investment funds. But at the same time, open architecture has gained ground: in several countries investment funds are significantly distributed by independent financial advisors (IFA) or by private banking departments of banks that do not necessarily manage those funds. This trend is especially relevant for foreign funds.

As a result, banks lead the distribution of savings products. In Italy and Spain, banks account for almost 90% of the distribution of savings products to individuals [2] . The performance of Italian banks is due to their high market share in financial products (securities, funds, life insurance), whereas Spanish banks dominate the market thanks to the share of bank deposits in the structure of household financial assets. Banks hold around three quarter of the market in France. Paradoxically, in Germany – a country where banks play a major role in the financing of the economy – banks are less dominant in the savings market than in other countries because bancassurance is as yet quite uncommon. The market share of banks in the distribution of savings products is still, however, close to 70%.

Up until the financial crisis, banks tended to focus on off-balance sheet financial products because selling securities, funds or life insurance products generated higher and more stable revenues for them than bank deposits. This was especially the case for long-term savings products, which provide banks with an income based on outstanding assets, more stable by nature than short-term investment flows.

The financial crisis has changed the terms of the equation for banks. The acute crisis in the interbank market in the last quarter of 2008 highlighted that financial institutions handling large and stable customer deposits have a beneficial impact on the systemic stability. The intensity of the interconnections between financial institutions is now widely recognized as a

[2] “Distribution channels of savings products in Europe”, OEE’s Letter n°16, October 2008

systemic risk factor. The liquidity of banks with large and stable client deposits is less dependent on other financial institutions.

Lack of stable resources in the balance sheet of banks was a factor in the development of the economic model "originate-and-distribute" whereby banks have provided cash by an extensive use of securitization. Supervisors and regulators in charge of the systemic risk questioned this model. The High Level Group chaired by Jacques de Larosière has highlighted the inadequacies of prudential regulation in this area[3]:

« *Liquidity issues are important in the context both of individual financial firms and of the regulatory system. The Group believes that both require greater attention than they have hitherto been afforded. Supervisors need to pay greater attention to the specific maturity mismatches of the firms they supervise, and those drawing up capital regulations need to incorporate more fully the impact on capital of liquidity pressures on banks' behaviour*."

In 2009, the transfers from investment funds to bank deposits can thus largely be explained by the commercial policy of banks. The increase of savers' risk aversion cannot entirely explain this move. Indeed, savers did not sell only equity products; they also withdrew huge amounts from bond funds, although the latter did not suffer the volatility and capital losses like equity products.

In 2009, the European Central Bank lowered short-term interest rates but savers could still enjoy a good remuneration for the long-term deposits. The task of banks willing to increase the share of bank deposits became tougher in 2010, when not only short-term but also long-term interest rates reached historical lows.

On the whole, non-transferable deposits held by households in the euro area increased significantly in the financial crisis (see table 2). The trend reversed in 2010, but the outstanding levels are still significantly higher than before the crisis in several countries.

France remains the country with the highest level of deposits per capita. This can be explained by the importance of "regulated" deposits benefiting from tax exemptions (notably the "Livret A" and the home ownership savings plan (Plan d'Epargne Logement).

The remuneration of deposits held by German savers is generally low and their outstanding amount at end of the first quarter of 2010 was lower, not only than the year before (as a consequence of the lowering of the whole interest rates curve), but even lower than before the financial crisis. The reason might be that the remuneration of many products offered to German savers increases with their ex-post maturity, rather than their ex-ante maturity: it depends on the past holding period rather than on the maturity when they are subscribed. A decrease in short-term interest rates has an immediate negative impact, including on the remuneration of new investment flows that savers intend to keep invested for a long period.

In Italy and Spain, the amount of non-transferable deposits is higher by more than 10% after the crisis than it was before, despite the reversal of the trend in Spain in 2010, due to the lowering of household revenues and savings capacity. It is worth noting that in Italy, savers also subscribe to bonds issued by banks or the Postal Bank. These holdings are perfect

[3] Larosière, J. (2009). The high-level group on financial supervision in the EU - The de Larosière report. Brussels.

substitutes for deposits, with a lower taxation than the latter. Their outstanding level is equivalent to that of deposits.

Table 2: Non-transferable deposits held by households at end of March 2010			
	Outstanding amounts (K€ per capita)	Variation/ End of March 2008	Variation/ End of March 2009
Euro area	10,5	+3,5%	-3,1%
France	12,3	+4,3%	-0,8%
Germany	11,4	-4,2%	-6,2%
Italy	7,3	+10,3%	+3,9%
Spain	9,4	+10,9%	-2,8%

4. Savings in the background of changing socio-demographic trends

Households increasingly need assistance to target their savings efforts and decide their asset allocation. Article 19-4 of MIFID provides that "*When providing investment advice or portfolio management the investment firm shall obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, his financial situation and his investment objectives so as to enable the firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him*."

Up to now most intermediaries have responded to this requirement by sending questionnaires to their clients as a means of clearing their own responsibility in case of contest by the client concerning the adequacy of their investment recommendations.

In the future, one of the challenges for intermediaries – first and foremost in private banking but also for mass affluent clients – is to help clients set-up asset-liability management techniques, which are already in place among institutional investors, particularly pension funds.

Methods used to give adequate advice to clients have to be improved. For example, Noël Amenc *et al*.[4] constructed an optimization portfolio model including asset liability management techniques. It allows dealing with private clients' objectives, constraints and risk aversion. They aim to take into account the changing objectives of an investor during his life cycle. Investors may have specific objectives or demands according to their age. For example, one may want to buy a first house, another to prepare for retirement. Many other factors must also be taken into account, such as tax regimes and bequest motives.

Socio-demographic changes have to be taken into account by intermediaries willing to provide consistent services to their clients, rather than just selling them products. They should help them to face three challenges: home acquisition, maintaining their income when retired and protecting themselves against the risk of dependency.

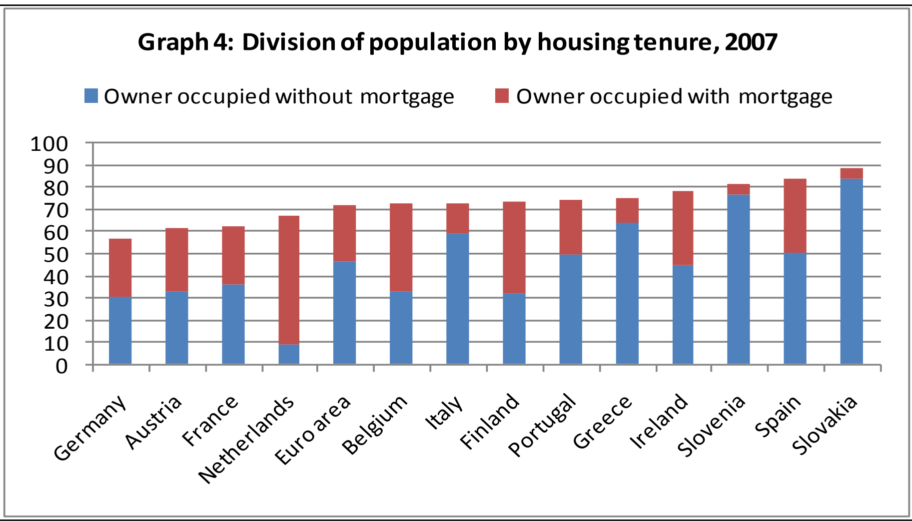
[4] Noël Amenc, Lionel martellini, Vincent Milhau, Volket Ziemann, "Asset-Liability Management in Private Wealth Management", EDHEC Risk, September 2009

Home acquisition

Non-financial investments (gross fixed capital formation - or GFCF - in national accounts) represent 8 to 10% of gross disposable income of households in the euro area. Home acquisition accounts for the most important share of those investments and GCFC underestimates the effort of those who are in the course acquiring their home. Indeed, when a household buys its house from another household (which is the most frequent case), the net transaction registered in National Accounts is null. In fact, household GFCF is rather representative of purchases of new dwellings by households.

More than two out of three inhabitants of the euro area are living in accommodation that they own, while one third of these homeowners have a mortgage credit outstanding.

In this area again, there is a large diversity across countries (Graph 4): Germany, Austria and France are under the area average. The Netherlands are the country of the euro area with the highest proportion of the population having an outstanding mortgage (59%). On the contrary, Slovakia, Slovenia, Greece and Italy have a proportion of inhabitants owning their home that is higher than the average, although the frequency of mortgages is very low in comparison to other countries. Finally, the proportion of owners is high in Spain, Ireland, and to a lesser extent Portugal, as a consequence of both factors: a traditional home ownership, often inherited, and a recent rapid growth of mortgages.



Source: EU-SILC 2007

Households – especially young households – are now experiencing a shift in difficulties when financing their first acquisition. Prices rose sharply until the financial crisis, and despite the following downturn, they are still high when compared to rents. In a long-term perspective, the decline in residential property prices that has occurred since mid-2008 is very far from eliminating the premium for homeownership versus renting. The ratio of house prices to rents is higher than its long-term average in most European countries, by 39% in France, 53% in Spain and 13% in Italy[5]. An ECB model forecasts that euro area real house prices should stop

[5] However, real estate prices are undervalued in Germany by 14% when compared to their long-term average.

decreasing at the end of 2010[6]. The model predicts depreciation by no more than 8%, a sharp contrast with the increase of 45% seen from 1997 to the peak of 2007.

The outlook for savings in home acquisition cannot be separated from other challenges, including the preparation of the post-retirement period. Botazzi *et al.* (2009)[7] measure the impact on savings of a decade of intense pension reforms in Italy. They find that Italian households have responded to the cut in pension benefits mostly by increasing real estate wealth.

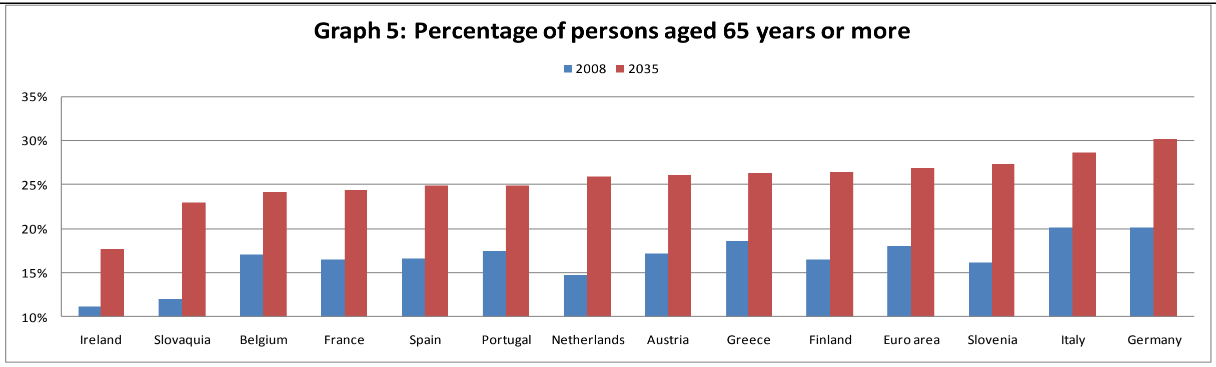
In several countries, public incentives have incited households to become owners of their dwelling. For instance, financial savings accumulated for the purpose of home acquisition are subsidised in Austria, Germany, France and Spain. Total or partial tax exemptions were also implemented on interest paid by mortgage subscribers. However, such subsidies have been removed for several years in the Netherlands, and the French government announced that they will be replaced by more targeted incentives for first acquisitions. More generally, access to credit has become more difficult for households since the financial crisis. Those willing to acquire their home will have to save more before the acquisition because prices are to remain high and the proportion of external financing will be less important than it used to be.

Pensions

The lengthening of life expectancy will change the parameters of the life cycle, which remains a fundamental driver of savings behaviour, though the model built by Modigliani[8] now has to be complemented by more factors to reflect empirical evidence. The longer individuals expect to live after they retire, the more they need to save.

It has to be recognized that pay-as-you-go systems mitigate the impact of demographic changes on necessary individual savings. Most governments have postponed the retirement age, which should help in maintaining the level of pensions received from both public and occupational pension systems. However, the average proportion of people aged 65 or more in the euro area population will roughly increase by 50% between now (18%) and 2035 (27%). Ireland is the only country where this proportion in 2035 will be comparable to current figures of the whole area. In Germany, it is expected that the elderly will account for more than 30% of total population.

[6] Luca Gattini and Paul Hiebert, "Forecasting and assessing euro area house prices through the lens of key fundamentals", ECB, Working paper n°1249, October 2010.
[7] Renata Bottazzi, Tullio Jappelli, Mario Padula, « The Portfolio Effect of Pension Reforms", OEE working paper, 2009
[8] Modigkiani, F., Brunberg, R. (1954). –"Utility Analysis and the Consumption Function: An Interpretation of Cross-Section Data", in Post-Keynesian Economics, K.K. Kuriharaed., Rutgers University Press.



Source: Eurostat, 2008

It is unlikely that only postponing the retirement age will solve the demographic problem. One of the issues is that unemployment of senior employees is most frequent than for the rest of the population, for various reasons. Therefore, European countries will also have to modify the two other parameters of the equilibrium of pension systems, namely contributions and benefits. The threat of both an increase of contributions and a decrease of benefits could raise the target level households aim search to reach for their financial and non-financial wealth.

Several governments have introduced public subsidies or tax exemptions in favour of individual pension savings products (pillar 3): the German Riester, the French Plan d'Epargne Retraite Populaire (PERP), the Irish Personal Retirement Savings Accounts, the Italian Forme individuali Pensionistico (FIP). In Germany, the Riester products were subscribed to by 13 million people. Most of these products are provide annuities. Nijman *et al.* (2009)[9] found that optimally individuals annuitize almost their entire wealth at retirement to capture the mortality credit. However, individual savings products are often hampered by the reluctance of savers towards annuity products. Products non-specifically designed as pension products, such as life insurance contracts, will permanently be preferred by the many individuals willing to prepare for their retirement.

Dependency

In an ageing population, the dependency risk will increase. It is expected that it will accelerate from 2025 or 2030, which should allow enough time for insurance contracts targeting this risk to mature. Although we miss consistent statistics in Europe on the development of this category of insurance contracts, anecdotic evidence shows that insurance companies propose contracts either specifically dedicated to the dependency risk or as a complement to life insurance contracts. There are also some collective occupational schemes, some of which are compulsory, while others are optional. Benefits can be paid as annuities or in capital. However, the development of these contracts remains limited because individuals hardly understand the conditions for benefiting from the compensations. They make the effort to understand these contracts when they are aware of this risk, often in their fifties, but the premium for individuals starting to subscribe to a dependency risk contract at this age is very high. Moreover, it is difficult for insurance companies to deal with the agency relationship, which should, in theory, incite households with the highest risks to subscribe to such contracts. A further difficulty is related to the uncertainty of the future prevalence of some categories of dependency and the ability of the medicine to cure them, especially with illnesses such as Alzheimer's disease.

9 Kim Peijnenburg, Theo Nijman, Bas Werker, "Optimal Annuitization with Background Risk and Equity Exposure During Retirement", Working paper for the OEE, 2009

Hence, the rising dependency risk should encourage individuals to save more, which in turn complements public solidarity and insurance contracts.

Conclusion

This article aimed to identify the main drivers of savings in the recent past and the foreseeable future. There are common features in most countries of the euro area: high savings rates, the important weight of banks in the distribution of savings products and sustained financial investments that offset capital devaluations caused by the financial crisis. Cultural, fiscal and institutional specificities in each country still, however, characterise the retail savings market in the euro area.

Savings in the euro area cannot be analysed separately from a wider European background. In 1999, the European Commission launched an ambitious legislative program whose main objective was to increase financial integration in Europe. Ten years on, it must be recognised that the retail financial market is still fragmented (Davydoff *et al.*, 2009)[10]. With the exception of investment funds, most saving products are still designed country by country, even by intermediaries that have operations in several European countries. Although the adoption of the Savings Tax Directive contributed to diminishing tax evasion on interest rate products, lack of harmonisation of tax rates is one of the main obstacles to the integration of the retail market.

Policymakers, regulators and financial intermediaries face difficult challenges to meet the needs resulting from socio-demographic changes. A common approach to these challenges would be a decisive tool for going ahead in Europe's integration.

[10] Didier Davydoff, Christian Gollier, Grégoire Naacke and Nicolas Véron, « An assessment of 10 years Financial Services Action Plan (FSAP) », study, for the European Parliament, Directorate-General for Internal Policies, Economic and Monetary Affairs