

Melbourne Mercer Global Pension Index

Dr David Knox

Worldwide Partner, Mercer

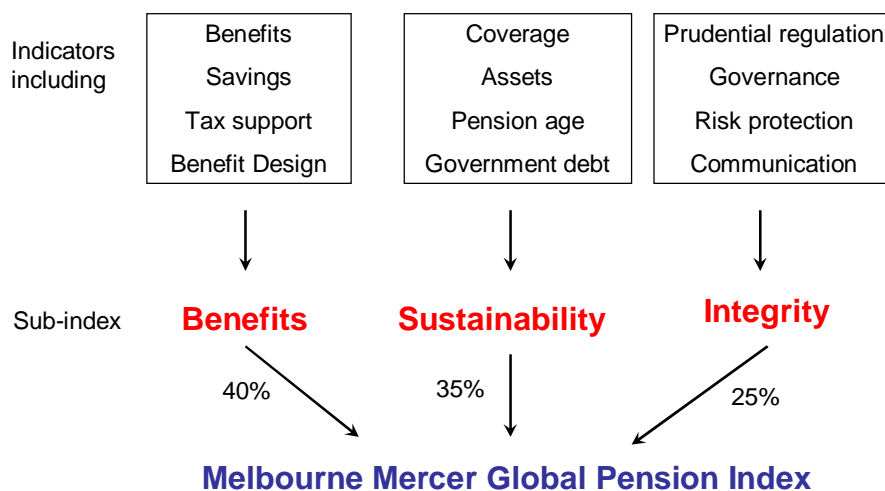
Introduction

Retirement income systems perform a critical role for both individuals and societies around the world as most countries grapple with the social and economic effects of an ageing population. Yet comparing retirement income systems is difficult and bound to be controversial as every system is different and has arisen from each country's particular economic, social, cultural, political and historical circumstances. Nevertheless there are certain features and characteristics of retirement income systems that are likely to lead to improved benefits, an increased likelihood of future sustainability of the system and a greater level of confidence and trust within the community.

With these objectives in mind, Mercer, in conjunction with the Melbourne Centre for Financial Studies, has begun a comparison of national retirement income systems around the globe through the development of an index value for each country's system. Such a comparison is also likely to help policy makers and governments who are planning to establish, review or reform their pension system.

The overall index value represents the weighted average of the three sub-indices as indicated by the following diagram, which also shows some of the indicators that are being used in each sub index.

Calculating the Melbourne Mercer Global Pension Index



The different weightings used reflect the primary importance of the benefits sub-index which represents the benefits that are currently being provided together with some important benefit design issues. The sustainability sub-index has a focus on the future and measures various indicators which will influence the likelihood that the current system will be maintained in the future. The integrity sub-index has focus on a private sector system and therefore has a more restrictive scope than the other two sub-indices. In total, more than forty indicators are being used.

The final index value for each country enables us to grade each country's system based on their index value according to the following table.

Index value	Grade	Description
>80	A	A first class and robust retirement income system that delivers good benefits, is sustainable and has a high level of integrity.
65-80	B	A system that has a sound structure with many good features but has some areas for improvement before it becomes an A grade system.
50-65	C	A system that has some good features but also has major risks and/or shortcomings that should be addressed. Without these improvements, its efficacy and/or long term sustainability can be questioned.
35-50	D	A system that has some desirable features but also has major weaknesses and/or omissions that need to be addressed. Without these improvements its efficacy and long term sustainability is in doubt.
<35	E	A poor system that may be in the early stages of development or a non-existent system

This pilot study of eleven countries has confirmed that no system is perfect. Indeed no country's system has an index value above 80, which we consider represents an A grade retirement income system. However several countries have an index value between 65 and 80 which represents a B grade system and with some improvements or changes in particular areas have the potential to be classified as an A grade system. Further details of each country's results will be discussed in the next edition of the Global RRF Perspective.

Details about the Index

The variety of pension systems around the world is considerable with a wide range of programmes representing great diversity. In addition, the lack of readily available and comparable data in respect of many countries provides additional challenges for this comparison. This situation is gradually improving and the OECD, in particular, has made significant progress in recent years. Nevertheless it must be recognised that reliable data in respect of some key indicators remains a significant issue. For this reason, the index uses a wide variety of data sources.

This data challenge should not, however, prevent a comparison of retirement income systems being conducted. The topic within the context of our ageing populations is too important to be ignored. Indeed, there is no doubt that policies and practices being conducted in some countries provide valuable lessons, experience or ideas for the development or reform of pension systems in other countries. This pilot study highlights both the considerable diversity and the positive features that are present in many systems. Notwithstanding these highlights, the study also confirms that no pension system is perfect and every system has some shortcomings. In that respect it is hoped that this study will act as a stimulus for each of the countries in the study (and indeed, other countries as well) to review their retirement income system against the indicators used within the index and to consider making improvements so that the future retirement incomes for their citizens can be improved.

Important Background

In its influential report *Averting the Old Age Crisis*, the World Bank (1994)¹ recommended a multi pillar system for the provision of old age income security comprising:

1. A mandatory publicly managed tax-financed public pension pillar;
2. A mandatory privately managed, fully funded pillar;
3. A voluntary privately managed fully funded pillar of personal savings.

More recently, the World Bank (2005)² has extended this three pillar system to a five pillar system with a zero pillar (or safety net) which represents a basic or social pension and a fourth pillar. This fourth pillar includes personal savings, home ownership and other assets which are held outside the pension system but which, nevertheless, can form an important role in financially supporting the individual during retirement.

Park (2009)³ in a recent Asian Development Bank paper suggests that a well designed pension system will include the following features:

- Broad based in terms of both coverage and the range of risks covered;
- Sustainable over time in terms of its actuarial and financial soundness;
- Robust so that it can withstand macroeconomic and other shocks;
- Affordable from individual, business, fiscal and macroeconomic perspectives;
- The provision of reasonable levels of post retirement income;
- The provision of a safety net for the elderly poor.

This list suggests a multiple set of objectives for any pension system and as Park correctly notes different societies will need to decide on the relative importance of each objective at a particular time. Furthermore, these priorities are likely to change over time as a society's economic and demographic circumstances change. Nevertheless they provide a useful checklist.

¹ World Bank (1994), *Averting the Old Age Crisis*, Oxford University Press

² Holzmann and Hinz (2005) *Old Age Income Support in the 21st Century*, The World Bank

³ Donghyun Park (2009) *Ageing Asia's Looming Pension Crisis*, ADB Economics Working Paper Series No. 165

As many commentators have noted, the ‘best’ system for a particular country at a particular time must take into account that country’s economic, social, cultural, political, and historical context. In addition, regulatory philosophies vary over time and between countries. There is no perfect pension system that can be applied to all the countries in the world at a particular time. It is not that simple! However there are some characteristics of all pension systems that can be tested or compared so that we can gain a better understanding of how each country is tackling the provision of retirement income.

The Melbourne Mercer Global Pension Index has grouped these desirable characteristics into benefits, sustainability and integrity. This study represents the first time that each country’s retirement income system has been considered from these three distinctive but complementary perspectives.

Benefits

The adequacy of benefits is perhaps the most obvious way to compare different systems. After all, the objective of any pension system must be to produce retirement income. Hence this sub-index considers both the minimum level of income provided (that is, pillar zero in the World Bank model) as well as the net replacement rate for a median income earner. However, savings for retirement are not only carried out through the formal pension programs and, as the World Bank notes, the fourth pillar can play an important role. Hence, we have also allowed for the net household saving rate.

Critical parts of delivering adequate benefits are the design features of the private pension system (or the second and third pillars of the World Bank taxonomy). Whilst there are many features that could be assessed we have considered the following four, each of which represents a feature that will improve the likelihood that adequate retirement benefits are provided:

- Are there taxation incentives for the median income earner to make additional voluntary contributions to the system?
- Is there a minimum age at which members can access their benefits, thereby limiting the leakage of benefits before retirement?
- Can a member’s entitlement be easily transferred or maintain its real value should the member’s circumstances change (for example, a change of employment)?
- Is part (or all) of the retirement benefit required to be taken as an income stream (or product) during the retirement years?

Sustainability

The long term sustainability of the current retirement income system in many countries has been raised as a concern, particularly in the light of the ageing population and the increasing old age dependency ratio. This sub-index therefore brings together several measures that will affect the sustainability of the current programs. Whilst some of the demographic measures, such as the old age dependency ratio (both now and in the future) are difficult to change, others such as the State pension age, the opportunity for phased retirement and the labour force

participation rate amongst older workers can be influenced, either directly or indirectly, by government policy.

An important feature of sustainability is that the long term risks are shared or, to put it another way, involve all the relevant stakeholders. Hence, this sub-index also considers the sharing of mandatory contributions between employers and employees and the importance of the private sector system through measuring coverage rates and the level of assets. Finally, given the key role that the public provision of a pension plays in most countries, the existing level of government debt represents an important factor affecting the system's long term sustainability.

Integrity

The third sub-index considers the integrity of the private sector pension system. After all, as most countries are relying on the private system to play an increasingly important role in the provision of the retirement income over the longer term, it is critical that the community has confidence in the ability of these private sector pension providers to deliver the retirement benefits in future years. This sub-index therefore considers the role of the prudential regulator, the required governance, the level of protection available to members from a range of risks and the level of communication required to be provided to members.

Selection of countries for inclusion in the index

This study includes a basket of countries from the Americas, Europe and the Asia Pacific region with a diversity of experience and pension systems to reflect the considerable range of approaches adopted around the world. The availability of comparable and reliable data from international sources (for example, from the OECD) and the presence of a Mercer office in each country (to collect information and to confirm our findings) represented additional criteria in the country selection.

The countries included in the Melbourne Mercer Global Pension Index are:

- Australia which has a three pillar retirement income system and is often considered to be a success
- Canada which has a well established and integrated pension system comprising both public and private sector pillars
- Chile which was the first Latin American country to introduce pension reform in 1981 and is often cited as an important example of pension reform
- China which is the world's most populous nation and has introduced significant pension reform in recent years
- Germany which represents Europe's largest economy and has a system that is distinct in that it relies heavily on book reserving, thereby introducing different features and issues
- Japan which has a well established pension industry with particular features but is now facing challenges that are more advanced than many countries
- Netherlands which does not have the typical European system but has features that are often positively discussed, including the use of collective funds and solvency requirements
- Singapore which represents a special case with its long established and fully funded Central Provident Fund

- Sweden which represents a Scandinavian system that is in transition from a pay-as-you-go basis to a fully defined contribution approach
- United Kingdom which has a very well developed pension industry, including a strong annuity market but one which is also undergoing significant change
- United States of America which is not only the largest economy in the world but also has a range of regulatory structures and approaches

Of course, it would have been desirable to include even more countries, but in view of the pilot nature of this initial study, this was not possible. It is hoped that this research will be extended in the future thereby allowing more countries to be included in the index.

Finally it is acknowledged that living standards in retirement are also affected by a number of other factors including the provision and costs of health services (through both the public and private sectors), the provision of aged care and the level of home ownership. However some of these factors can be difficult to measure within different systems and, in particular, difficult to compare between countries. It was therefore decided, within this pilot study, to concentrate on indicators that directly affect the provision of retirement income, both now and in the future. Therefore these results do not claim to be a comprehensive measure of living standards in retirement; rather they are focused on the provision of retirement income.

September 2009