



## PENSION NOTES

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### 2020 MERCER CFA World Pension Index: The impact of Covid-19 on pensions

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#### Executive Summary

The 2020 edition of the MERCER CFA World Pension Index, which assesses the pension systems of 39 countries, shows that Latin America faces significant challenges in this area. Chile ranks thirteenth globally, among the countries in category B, with 67 out of 100 possible points. Further behind, in category C, are Colombia ranked 21st, with 58.5 points; Peru 24th, with 57.2 points and Brazil 26th, with 54.5 points. Mexico ranks 35th, with 44.7 points and Argentina ranks second-last with only 42.5 points. The latter two countries are in category D.

This Pensions Note analyzes the results of the Latin American pension systems and the reforms or improvements they require.

It analyses the economic impact of Covid-19, which is intensifying financial pressure on pension systems in all countries already facing population aging difficulties. In fact, the global health crisis has negatively affected pension systems in the following aspects: increased spending and public debt, to finance higher health expenditure and aid to the population, reducing the capacity of future governments to support their elderly populations; an economic recession that has increased unemployment, informality and self-employment and reduced social security contributions and taxes; low interest rates and low returns on pension fund investments,

and massive authorizations of mandatory savings withdrawals in some countries.

The note describes the cases of countries that have allowed the early withdrawal of pension funds or have temporarily reduced pension contributions, to provide additional funds to their inhabitants. Faced with this measure, the negative opinion of international agencies regarding this matter are notable. The International Organization of Pension Supervisors (IOPS) stated that “Early access to pension savings should be limited, temporary and proportionate to real needs,” whereas the Organization for Economic Cooperation and Development (OECD) stated that “Access to retirement savings must remain an exceptional measure based on specific individual circumstances and the regulations that already exist for such purposes.” It also highlights the fact that the two best-evaluated pension systems in the Mercer CFA Index, the Netherlands and Denmark, have not allowed early access to pension funds, despite the fact that the assets of each of these pension systems are more than 150% of the GDP of their countries.

## I. Introduction

Financial security in retirement is essential for both individuals and societies, since most countries are facing the social, economic and financial effects of an aging population. The measures to contain the pandemic have generated an economic situation characterized by an accentuation of the downward trend of interest rates, reaching historically low levels, a recession that has negatively affected employment and its formal-informal structure and contributions to social security, and a reduced return on pension fund investments. This is putting additional financial pressure on existing pension systems.

The 2020 MERCER CFA INSTITUTE World Pension Index was recently released, incorporating two new countries, Belgium and Israel, and analyzing the pension systems of 39 countries, representing almost two thirds of the world population.

The World Pension Index reveals how prepared the pension systems of the different countries are for facing a future with population aging, through three sub-indices: **Adequacy, Sustainability and Integrity**. These sub-indices involve more than 50 indicators, which in this edition pose new questions related to public pension expenditure, investment with ESG (environmental, social and corporate governance) criteria and support for caregivers of the elderly.

The three sub-indices are weighted in different percentages for the overall index calculation. Thus, the suitability subindex, which represents the benefits provided, along with some important features of the design of the system, is weighted at 40%. The sustainability sub-index, which focuses on the future and measures several indicators that will influence the probability of the existing system providing benefits in the future, is weighted at 35%. And the integrity sub-index,

which includes several elements that influence corporate governance and general operation of the system, which in turn affect the level of trust that citizens have in their pension system, is weighted at 25%.

Despite the above, it should be noted that the evolution of the global index responds to multiple factors, which do not necessarily reflect the quality of the pension systems. A good example is the suitability sub-index, which considers, among other things, the replacement rate (amount of benefits paid compared to salary), so that the evaluation of this sub-index will depend on factors such as the contribution rate, the retirement age and early withdrawals of funds. In this regard, according to the CEO of Mercer Chile, Daniel Nadborny, the early withdrawals of pension funds in this country in 2020 will negatively affect the assessment of the pension system, although this has nothing to do with the benefits of the individually funded system.

### 2020 Results

Table 1 shows the countries grouped according to the "category" of their pension systems (column "Grade"), which is assigned depending on the global index ranking of each country.

The study confirms that the Netherlands and Denmark have the best pension systems in the world, both receiving an "A" grade in 2020. Although the Netherlands maintained the highest ranking in 2020, it was noted that its system is currently undergoing significant reform. These changes indicate that there is always room for improvement. At the opposite end, Thailand had the lowest index value (40.8).

**Table 1**

Grade	Index Value	System	Description
A	>80	Netherlands, Denmark	A robust and first-class pension system that offers good benefits, is sustainable and has a high level of integrity
B+	75–80		A pension system with a solid structure, with many good features, but with some areas that require improvement, differentiating it from a category A system.
B	65–75	Israel, Australia, Finland, Sweden, Singapore, Norway, Canada, New Zealand, Germany, Switzerland, Chile and Ireland.	
C+	60–65	United Kingdom Belgium Hong Kong SAR * USA Malaysia, France	A pension system that has some good features, but also significant risks and/or shortcomings that need to be addressed. Without these improvements, their long-term effectiveness and/or sustainability may be in question.
C	50–60	Colombia, Spain, Saudi Arabia, Peru Poland, Brazil, South Africa, Austria, Italy, Indonesia and South Korea	
D	35–50	Japan, China*, India, Mexico, Philippines, Turkey, Argentina and Thailand	A pension system with some desirable features, but also with significant weaknesses and/or omissions that must be addressed. Without these improvements, its effectiveness and sustainability are in doubt.
E	<35	Not Applicable	A poor pension system that may be in the early stages of development or may not exist.

**Source:** Based on the 2020 MERCER CFA Institute World Pension Index, page 6.

\* In this report, China refers to the retirement income system in mainland China, whereas Hong Kong SAR refers to the retirement income system in Hong Kong, a Special Administrative Region (SAR) of China.

## General recommendations

Although each pension system reflects a unique history and context, there are some common areas for improvement, as many will face similar problems in the coming decades. As the OECD noted in 2017: "OECD countries should not wait until the next crisis to implement the reforms necessary to address increased longevity, increased risk of inequality in old age and changes in employment patterns." In view of the effects of Covid-19, these adjustments are now more relevant. As Winston Churchill said: "Never let a good crisis go to waste."

The MERCER CFA Institute proposes a series of reforms to improve the long-term results of pension systems:

- Increase coverage of dependent workers, including workers in non-standard jobs (GIG economy), and self-employed workers in the private pension system, recognizing that many people will not save for the future without a mandatory or automatic enrollment element.
- Raise the official retirement to reflect the increase in life expectancy, thus reducing the costs of publicly funded pensions.
- Promote greater participation of the elderly workforce, which will increase the savings available for retirement and limit the ongoing increase in the length of retirement.
- Encourage or require higher levels of private savings, both within and outside the pension system, to reduce future dependence on the public pension, while adjusting the pension expectations of many workers.
- Introduce measures to reduce the gender and minority group gaps in many pension systems.

- Reduce the draining of pension savings prior to retirement, thus ensuring that those funds are used for financing pensions.
- Review the public pension indexation level, since the method and frequency of pension increases are essential to ensure that their real value is maintained, safeguarding their long-term sustainability.
- Improve the corporate governance of private pension plans and introduce greater transparency, to improve the confidence of pension plan members.

## The situation in Latin America

The 2020 edition of the MERCER CFA World Pension Index shows that Chile ranks thirteenth globally, with 67 out of a possible 100 points, ranking among the countries in category B. Colombia ranks 21st, with 58.5 points; Peru 24th, with 57.2 points and Brazil 26th, with 54.5 points, despite having the most robust system of complementary individually funded corporate plans in the region. These countries are classified in category C. Mexico ranks 35th, with 44.7 points and Argentina ranks second-last with only 42.5 points. The latter two countries are in category D. When comparing the results with those of the previous year, an overall decline is observed in Latin American countries.

MERCER CFA's improvement proposals for each of the Latin American countries included in the study are presented below:

**Chile:** (i) Increase the minimum level of support for the poorest elderly people; (ii) Increase the retirement age of women; (iii) Introduce a minimum age for accessing private pension retirement benefits.<sup>1</sup> and; (iv) Require that the annual pension plan reports to be available to all members<sup>2</sup>.

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<sup>1</sup> The introduction of a minimum age is debatable, because it exists unless pension level conditions for early retirement are met.

<sup>2</sup> This is despite the fact that Chilean AFPs must submit

a quarterly report on the movements of the mandatory and voluntary accounts, and if no movements are recorded, they must communicate the status of both accounts at least once a year.

**Colombia:** (i) Increase the minimum level of monetary support for the poorest elderly people; (ii) Raise household savings levels; (iii) Increase the coverage of workers in pension plans and; (iv) Gradually increase the official retirement age.

**Peru:** (i) Introduce a minimum level of support for the poorest elderly people; (ii) Increase the coverage of workers in pension plans, thus increasing the level of contributions and assets managed; (iii) Allow people to gradually retire while receiving a partial pension and; (iv) Improve the governance requirements of the private pension system.

**Brazil:** (i) Introduce automatic adjustments in the official social security retirement age, linking it to changes in life expectancy; (ii) Introduce a minimum level of mandatory contributions in a retirement savings fund and; (iii) Increase the coverage of workers in occupational pension plans through automatic enrollment, thus increasing the level of contributions and assets managed.

**Mexico:** (i) Introduce the requirement that part of the private pension plan pension must be considered an income stream; (ii) Increase the level of contributions to the individual account system, thus increasing the level of assets managed over time; (iii) Improve governance requirements for the private pension system, including the need for minimum levels of individual funding in defined benefit plans and; (iv) Improve the level of communication required with members of private pension plans.

**Argentina:** (i) Continue to increase the pension available to the poorest elderly people; (ii) Increase the coverage of workers in occupational pension plans through automatic enrollment, thus increasing the level of contributions and assets managed; (iii) Introduce a minimum level of mandatory contributions in a retirement savings fund

and; (iv) Improve the regulation of the private pension system.

Some of the above proposals for improvement have recently been incorporated by some countries, such as increasing the minimum level of support for the poorest elderly individuals (Chile) and increasing the level of contributions to individual accounts (Mexico).

Dr. David Knox, Senior Partner at Mercer and lead author of the study, said: "The economic downturn caused by the global health crisis has led to lower pension contributions, lower returns on pension fund investments, and higher public debt in most countries. Inevitably, this will affect future pensions, which means that some people will have to work longer, while others will have to settle for a lower standard of living when they retire." Moreover, Dr. Knox added that Covid-19 has also increased gender inequality in many pension systems, as the sectors most affected by the pandemic have been those in which women make up more than half of the workforce, such as hotels and the catering industry.

The level of public debt has increased in many countries after the appearance of Covid-19. This increased debt is likely to constrain the ability of future governments to support their elderly populations, either through pensions or through the provision of other services such as health or care for the elderly.

In addition, some governments have allowed early temporary access to pension savings to improve household liquidity. For example, Australia allowed people whose income had decreased by more than 20% to access their pension assets for an amount of up to AUD 20,000 (approximately \$ 14,000). India allowed partial withdrawals from pension funds for the treatment of Covid-19 and a payment from the pension fund that did not exceed three months of salary and benefits. In Peru, individuals were allowed to withdraw

up to 25% of their savings from their individual accounts, with a limit of PEN 12,900 (USD 3,685), whereas Chile twice authorized individuals to voluntarily withdraw 10% of their individual pension funds, with a maximum of USD 5,600.

In Spain, another approach was adopted in which eligible participants could receive a benefit equal to the lowest amount between their lost wages during the pandemic and a government formula. In contrast to these limits, the United States allowed withdrawals of up to \$ 100,000 to qualified individuals in eligible retirement plans, along with favorable tax treatment.

It is interesting to note that the two best-evaluated pension systems in the Index, the Netherlands and Denmark, have not allowed early access to pension funds, despite the fact that the assets of each of these pension systems are more than 150% of the GDP of their countries.

These examples raise the question of the purpose of a pension system based on individually funded savings and whether, in extreme circumstances, a limited part of the assets accumulated by a person can be available before retirement. There is no single answer to this question, as individually funded savings systems, unlike PAYGO systems, provide the opportunity for alleviating the financial pressure on their members in such circumstances. On the other hand, easy access to an accrued benefit is a very attractive option for many people, who may have a limited understanding of its impact on their future pension. Therefore, as the International Organization of Pension Supervisors (IOPS) points out: "Early access to pension savings should be limited, temporary and proportionate to real needs."

The OECD goes even further by commenting that "Access to retirement savings must remain an exceptional measure based on

specific individual circumstances and existing regulations governing such matters."

Another way in which additional funding was provided during the pandemic was by reducing the level of contributions normally paid to pension plans. For example, in Indonesia the Social Security contribution rate was reduced from 2.0% to 0.2% of salary between May and July 2020, and in Thailand the 5% contribution required of employers and workers was reduced to 4% and 1%, respectively, for three months. In Colombia, members of private pension plans were able to opt for a reduction in their contributions for two months, from 16% to 3%, whereas in Peru employers did not deduct the 13% pension contribution from salaries in April and May 2020. In Singapore, the scheduled increase in contribution rates for older workers was postponed for one year, until January 2022.

These reductions in short-term contribution levels are likely to have fewer long-term consequences for individuals, compared to early withdrawal of accumulated savings. In any case, these public policies will probably have a material impact on the adequacy, sustainability and integrity of pension systems in the Global Pension Index, which will influence the ranking of the countries that adopted them in the coming years.

There are other trends that affect pension systems, aggravated by Covid-19:

- The lack of coverage of private pensions and any retirement savings, among many workers in both developed and developing economies, either due to informal labor markets or the growing importance of "contract employment."
- A deterioration in the financing position of most defined-benefit schemes which, in some cases, could lead to their closure, and the development of defined contribution schemes.

- The decision of some people to postpone retirement and thus make up their pension deficit through additional years in the workforce.
- The need to increase pension contributions, with a corresponding reduction in current consumption, which will have short-term economic effects.
- An attempt by some members of pension plans to increase the rate of return on the investments of their funds, increasing risk levels in their investment portfolios.

### **Decisions of pension plan members**

The common behavior of many pension plan members during a financial crisis is to flee to safety, which often occurs after the stock market has crashed. These stocks are often available to people with personal accounts in defined contribution plans (CDs) or mutual funds.

This behavior was observed in DC plans in Australia, Indonesia, Ireland, New Zealand and the United States. There was also a shift towards gold-based investments in Turkey. Interestingly, as the equity market rallied (at least to some extent), the evidence is that some of these members have returned to investing in stocks, probably due to the very low interest rates available for cash investments.

As individuals are given greater responsibility in many pension systems, this often requires them to be able to make investment decisions and switch between different asset classes.

Thus, it is to be expected that there will be a movement towards safer investments in times of financial crisis, although this decision may not be the right decision in the long term. Hence, the need for sound education for members and good communication from

pension fund managers are especially necessary in such times.

### **Conclusions**

The Mercer CFA index is a useful tool for evaluating the design of pension systems worldwide, comparing between countries and looking for opportunities for improvement, notwithstanding the fact that their different components must be carefully analyzed, since the global index may be influenced by the impact of factors such as contribution rates, retirement age and early withdrawal of funds, without necessarily reflecting the capacity and efficiency of pension programs to provide adequate pensions to workers.

In the Latin American countries, the results are quite dissimilar, ranging from 67 points in Chile to 42.5 points in Argentina. Although the crisis caused by the pandemic has intensified the financial pressures facing pension systems in the region, both now and in the future, the guidelines for achieving long-term improvements in the system are clear.

It is worth highlighting the importance of the progress of the individually funded systems worldwide. On the one hand, they have provided resources to members of the plans in times of crisis. But more importantly, they have been essential in the payment of sustainable pensions over time, which is evident when observing that the two countries best evaluated by the Mercer index, the Netherlands and Denmark, pay a high percentage of their replacement rates through these mechanisms, i.e., 70% and 68.2% respectively. In fact, as is evident, the Mercer Institute itself proposes a general measure: "Encourage or require higher levels of private savings, both inside and outside the system to reduce future dependence on the public pension."

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