PENSION NOTES

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2018 Mercer Global Pensions Index: Lessons for Latin America

Executive Summary

The Mercer Global Pensions Index assesses the pension systems of 34 countries, revealing that Latin America has significant challenges in this area. Chile ranks eighth among the best countries in the world, with 69.3 out of a possible 100 points; Colombia ranks 14th with 62.6 points; Peru 16th, with 62.4 points; Brazil 21st, with 56.5 points; Mexico 31st, with 45.3 points and Argentina ranks last, with only 39.2 points.

This Pensions Note analyzes the results of the pension systems of these countries in each of the sub-indices comprising them, namely Adequacy, Sustainability and Integrity, the weaknesses of the aforementioned Latin American pension systems and the reforms or improvements they require.

Chiles has good Sustainability and Integrity indicators, even though the Adequacy indicator is slightly below the average of the countries analyzed, pointing to an opportunity for improvement in this indicator, which, among other things, compares income and benefit levels.

Colombia and Brazil have good adequacy indicators, a slightly below-average Integrity indicator, and a low Sustainability indicator, which is particularly bad in the case of Brazil, due to the deficits of its PAYGO systems.

Peru, on the other hand, has an above-average assessment of its Adequacy and Sustainability indicators, but a low Integrity assessment, partly due to the low coverage of its pension system.

Mexico has a good Sustainability indicator assessment, but below-average assessments of its Adequacy and Integrity indicators, due to the level of benefits it can provide with a contribution rate of only 6.5% of wages and the low coverage of its pension system.

Finally, Argentina ranks last in the Mercer Index because its three sub-indices are significantly below the average of the rest of the countries assessed, indicating that its pension system is in need of profound reform.

I. Introduction

At the end of last year, the 2018 Mercer Global Pension Index was published. This was its 10th edition since its outset in 2009, when it analyzed the pension systems of 11 countries, compared to the 34 countries it covers today.

The Mercer Global Pensions Index reveals the countries with pension systems that are more and less prepared to face a future with an aging population, through three sub-indices: Adequacy, Sustainability and Integrity, with more than 40 indicators.

In the Adequacy or Sufficiency sub-index, it considers indicators such as benefits, system design, savings, tax support, home ownership and asset growth, with a 40% Global Index weighting.

The Sustainability sub-index focuses on the future, on the probability of the system being able to carry on delivering existing benefits; it considers indicators such as pension coverage, total assets, contributions, demographics, government debt and economic growth, with a 35% weighting.

Finally, the integrity sub-index is weighted at 25% and considers indicators such as regulation, governance, protection, communications and costs.

Table 1 shows the value of the index per country, together with the value of each one of the three sub-indices. Each index value represents a score of between 0 and 100.

The index shows that the Netherlands and Denmark, with scores of 80.3 and 80.2 respectively, offer the best retirement systems, with sustainable benefits and a high level of integrity, clearly demonstrating their adaptation to population aging.

Nonetheless, the results regularly revealed the growing tension between the Adequacy and Sustainability of pension systems. This was particularly evident when examining the European results. Denmark, the Netherlands and Sweden obtain high Adequacy and Sustainability scores, whereas Austria, Italy and Spain obtain good Adequacy and poor Sustainability ratings, indicating important areas in need of reform.

Dr. **David Knox, the study manager and a senior partner at Mercer Australia,** says that the natural starting point for a world-class pension system is to ensure the right balance between Adequacy and Sustainability. *"This is the challenge facing politicians," said Dr.* Knox *"For example, a system that provides very generous benefits in the short term, is unlikely to be sustainable, whereas a sustainable system could provide very modest benefits for many years. The question is: what is an appropriate compensation? "*

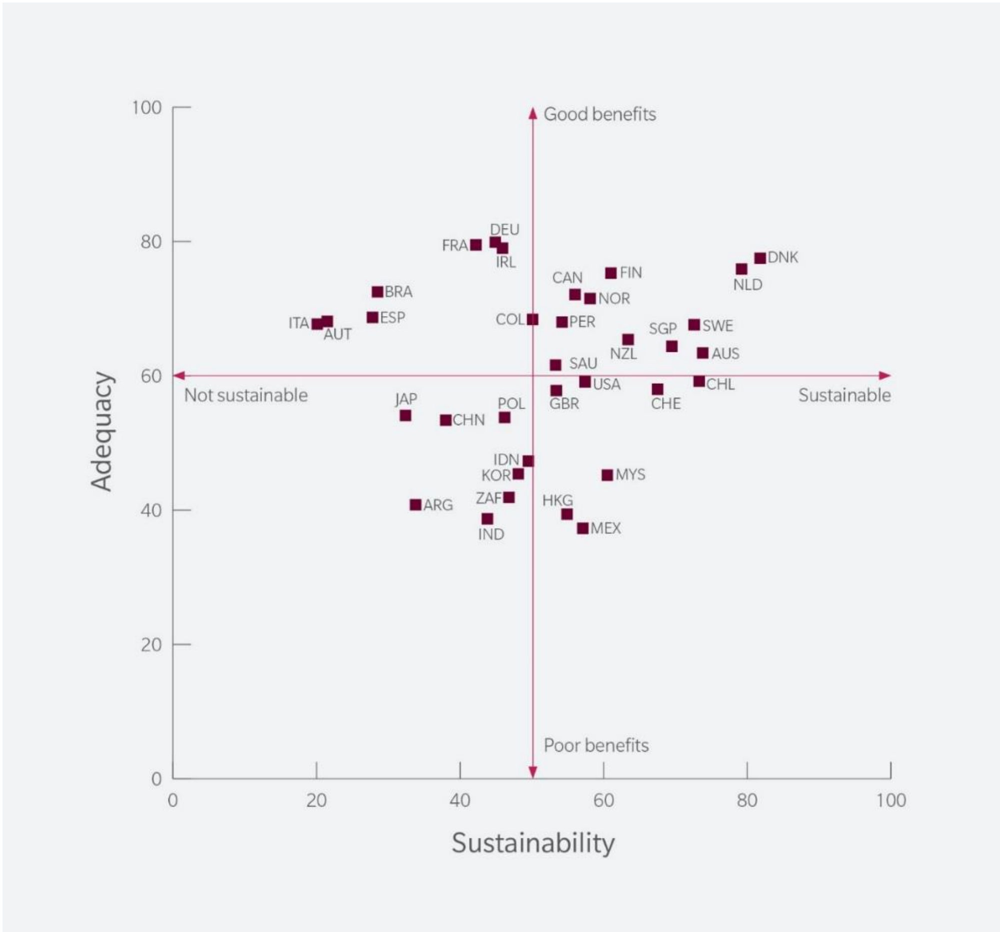
As highlighted in Graph No. 1, all systems should consider adjusting their strategies to move towards the upper right-hand quadrant, which entails the provision of adequate and sustainable benefits over time.

Table No. 1: Mercer's Global Pension Index assessment based on sub-indices

System	Overall Index Value	Sub-Index Values		
		Adequacy	Sustainability	Integrity
Argentina	39.2	40.8	33.8	44.1
Australia	72.6	63.4	73.8	85.7
Austria	54.0	68.1	21.5	76.7
Brazil	56.5	72.5	28.5	70.1
Canada	68.0	72.1	56.0	78.2
Chile	69.3	59.2	73.3	79.7
China	46.2	53.4	38.0	46.0
Colombia	62.6	68.4	50.1	70.9
Denmark	80.2	77.5	81.8	82.2
Finland	74.5	75.3	61.0	92.1
France	60.7	79.5	42.2	56.5
Germany	66.8	79.9	44.9	76.6
Hong Kong SAR	56.0	39.4	54.9	84.2
India	44.6	38.7	43.8	55.2
Indonesia	53.1	47.3	49.5	67.4
Ireland	66.8	79.0	45.9	76.6
Italy	52.8	67.7	20.1	74.5
Japan	48.2	54.1	32.4	60.7
Korea	47.3	45.4	48.1	49.3
Malaysia	58.5	45.2	60.5	77.1
Mexico	45.3	37.3	57.1	41.6
Netherlands	80.3	75.9	79.2	88.8
New Zealand	68.5	65.4	63.4	80.6
Norway	71.5	71.5	58.1	90.2
Peru	62.4	68.0	54.2	65.1
Poland	54.3	53.8	46.2	66.4
Saudi Arabia	58.9	61.6	53.3	62.6
Singapore	70.4	64.4	69.5	81.2
South Africa	52.7	41.9	46.8	78.2
Spain	54.4	68.7	27.8	68.6
Sweden	72.5	67.6	72.6	80.2
Switzerland	67.6	58.0	67.5	83.2
UK	62.5	57.8	53.4	82.9
US	58.8	59.1	57.4	60.2
Average	**60.5**	**61.1**	**52.0**	**71.6**

Source: 2018 Melbourne Mercer Global Pension Index, page 7.

Graph No. 1: Adequacy to Sustainability ratio



Source: 2018 Melbourne Mercer Global Pension Index

It is therefore not surprising that Holland leads the Mercer Global Index, which measures the three aforementioned indices, followed by Denmark (2nd), Finland (3rd), Australia (4th), Sweden (5th), Norway (6th).), Singapore (7th), Chile (8th), New Zealand (9th) and Canada (10th). The fact that 9 of the countries ranked in the top 10 of the Mercer Index are located in the upper right-hand quadrant of the above graph (Adequacy - Sustainability), is an indication of the importance assigned to these factors by the authors.

II. The situation in Latin America

According to the Melbourne Global Pension Index, Chile ranks eighth among the best countries in the world, with 69.3 out of a possible 100 points. Colombia ranked 14th, with 62.6 points, and Peru, ranked 16th with 62.4 points, are still subject to significant risks and deficiencies, whereas Mexico, ranked 31st, with 45.3 points and Argentina, which ranks last, with only 39.2 points, have serious shortcomings in their retirement planning systems that put their sustainability at risk. Brazil ranks in an intermediary position (21st) with 56.5 points, despite having the most robust system of individually funded corporate complementary plans in the region.

Each one of the Latin American countries included in the Mercer study are analyzed individually below.

Chile ranks eighth, mainly due to the maturity and the adjustments made to its innovative AFP model implemented in the 80s, and subsequently implemented by other countries. The assessment is mainly due to good Integrity and Sustainability indicator scores. Nonetheless, its Adequacy indicator scores slightly below the average of the countries analyzed, pointing to an opportunity for improvement in this indicator, which, among other things, reflects benefit vs. income levels.

It seems that the Chilean government shares Mercer's diagnosis, since a bill of law pointing in that direction was recently submitted to Congress (see FIAP Pensions Note No. (33), which, among other aspects, gradually raises the contribution rate by 4 percentage points, approaching the average rate of the OECD countries and allowing a 40% increase in self-financed pensions in the long term; a significant increase in the benefits of the solidarity pillar, which will mainly benefit low-income individuals who have not contributed to their pensions, or have done so sporadically; the creation of additional State contributions for middle-income workers who have regularly contributed to the pension system; the introduction of a subsidy and dependency insurance for senior citizens who may require assistance from others in going about their daily activities, and the introduction of incentives for people to voluntarily postpone retirement, thus increasing their pension amounts. Furthermore, after a drawn-out process, a law was finally passed that makes it mandatory for self-employed workers who issue fee slips to gradually start paying social security contributions. The Government is also studying the incorporation of other independent workers into the social security system.

Although Colombia and Peru implemented the Chilean AFP system, they are located at a lower level. Colombia, has an average assessment in the Adequacy indicator, but is slightly below the average in the Sustainability and Integrity indicators. Thus, the improvements to its pension system necessarily involve increasing the coverage of pension plans, which currently cover only 35.9% of workers; raising retirement ages based on life expectancy increases and restructuring the two parallel pension systems (PAYGO[1] and individual funding), which are mutually exclusive, towards a sole individually funded contributory system, which eliminates the arbitration of the most informed individuals, the growing public deficit and strong regressivity due to the existence of "special" pensions that provide disproportionate benefits to certain population groups, focusing the State’s efforts on the administration of protection to the most needy (PEBS and Colombia Seniors).

Peru has above-average Adequacy and Sustainability indicators, but is below-average in the Integrity indicator. Like Colombia, it has to increase the coverage of pension plans, which currently cover only 17.3%[2] of workers, and also review the contribution rate, which is similar to the existing Chilean rate, and encourage voluntary pension savings. But the most urgent requirement is the elimination of the

[1] Known as the Average Premium Plan, whose deficit was 4% of GDP in 2017.

[2] 17.3% of coverage refers only to contributors to the private pension system, and does not take into account 93% of the public system. (contributors / EAP). If the number of affiliates is taken into account, coverage is 38% for the private system and 26% for the public system. (members / EAP).

lump sum withdrawal of 95.5% of accumulated pension savings by individuals who retire early, or at the official retirement age.[3], which has been used up by 95% of Peruvians, leaving them and their families without health coverage or the protection of a pension. Likewise, the withdrawal of 25% of the pension funds to finance initial down-payments or amortization of mortgage loans (housing), which around 50,000 Peruvians have already done, must be restricted. Housing is undoubtedly an important necessity, which must be resolved, but it should not be done at the expense of pensions, since low pension contribution rates do not suffice for financing other benefits, however laudable they may be.

Brazil ranked below average in the global ranking, mainly due to the its poor results in the Sustainability sub-index, since its social insurance system operates as a defined benefit and not funded plan, for both public and private workers, with pension expenditure equivalent to 13.6% of GDP in 2017 (with a deficit of 4.25% of GDP), which could grow to 23% of GDP by 2060, if no reforms are implemented. This is despite the fact that Brazil has the largest volume of retirement savings assets in the region in the individual and complementary corporate savings plans. On February 20, 2019, the incumbent government submitted a new bill of law to Congress.[4] which, among other aspects, establishes minimum retirement ages of 62 and 65, for women and men respectively.[5]; increases to 40 years of contributions for accessing a full pension; increases the number of years of contributions required for accessing a pension from 15 to 20; the minimum age to start receiving the Continuous Cash Transfer Benefit (BPC) increases from 65 to 70.[6]; reduces the amount of the Widow's Pension from 100% of the originator's pension to 50% for the widow and 10% for each child, and proposes the establishment of an individually funded system based on the Chilean model for people entering the labor market, all of this aimed at reducing the significant and increasingly unsustainable deficit of the Brazilian PAYGO system.

Further on in Mercer's Global Pension Index comes Mexico, with Argentina last on the list as the worst system assessed, noting that "these pension systems have significant weaknesses or omissions that need to be addressed. Without these improvements, their efficacy and sustainability are in doubt."

"Mexico, particularly, has a score very similar to the United States in Sustainability, due to the Reform of the Social Security System which converted it from a Defined Benefit to a Defined Contribution system (Afores). However, its average drops when measuring the Adequacy sub-index, which reflects the universal pension adjustment, in which Mexico ranks the lowest with a score of 37.3 points, similar to that of India. There are areas of opportunity in corporate private plans, related to the practice of paying lump sums (instead of a monthly pension), as well as the low replacement rates expected in retirement."[7]. It is worth mentioning that

[3] More than 100,000 Peruvians have withdrawn 95.5% of their pension savings in recent years, 35% at the official retirement age and the remaining 65% in advance.

[4] The pension reform proposed by the previous government (Michel Temer 2016-2018) failed to make it through Congress.

[5] There is currently no such limit, and 30 and 35 years of contributions are required of women and men, which means that a significant number of Brazilians are retiring at fifty-odd years of age (the average retirement age in the private system is 55).

[6] Pays a minimum wage to destitute senior citizens (family income less than 25% of the minimum wage). Destitute senior citizens between 65 and 70 are paid 400 Reals per month.

[7] André Maxnuk, CEO Mercer Mexico.

with a contribution rate of only 6.5% of salary, it is very difficult, if not impossible, to provide quality pensions.

Argentina ranks last in the Mercer index because its three sub-indices, namely Adequacy, Sustainability and Integrity, are significantly below the average of all the countries assessed, indicating that its pension system is in dire need of profound reform.

It is important to remember that in 2008 Argentina eliminated the individually funded system that was created in 1994 (which was based on the Chilean model). All workers' savings accumulated in the Pension Funds Managers (AFJPs) were expropriated and transferred to the National Social Security Administration (ANSES), a government agency, which adequately financed the payment of PAYGO pensions with these resources, although public spending more than doubled in the last decade to finance its considerable deficit, which amounted to 11.3% of GDP in 2017. In fact, pension expenditure in 2017 was almost half of the government's total public expenditure and revenue from contributions to the pension system accounts for only 60% of pension payments (see FIAP Pensions Note No. 29).

Another way of viewing the problem of the Argentine pension system is the ratio of contributors (11.3 million) to beneficiaries (8.4 million), i.e. there are only 1.4 contributors for each pensioner.

The pension reform came into effect in February 2018, to alleviate debilitated public finances, modifying the pension adjustment formula and encouraging voluntary postponement of the retirement age. These are necessary but clearly insufficient changes, considering the Mercer assessment and the significant population aging.

III. Looking Ahead

For Latin America, according to André Maxnuk, "there is still a long road ahead for raising awareness of the importance of long-term savings and closing the gap between the projections of future benefits and the current level of funding. Governments and society need to face this issue with the awareness that the chances of an affordable solution diminish with each passing day, leading to the need for tough measures in the mid-term."

This is especially relevant if we consider that most Latin American countries, due to birth rate reductions and life expectancy increases, will experience significant population aging in coming decades, reaching figures similar to those we see in Europe today, increasing the demands on the pension systems of the region, with the aggravating circumstance that our countries have not reached European levels of wealth and development and that our pension systems cover only a part of the population (coverage).

Dr. Knox adds that it will not suffice for a system to be sustainable or adequate; an emerging dimension of the debate on what constitutes a world-class system is the "coverage" and the proportion of the adult population participating in the system. *"In some countries, extensive coverage has been successfully achieved through mandatory pension systems in the workplace or, in some cases, automatic enrollment agreements." "However, with the changes affecting people who work all over the world, we must ensure that these systems include everyone, so that the entire workforce saves for its future. This includes contractors, self-employed workers and anyone who has any type of income support, whether parental leave, disability income or unemployment benefits."*

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