Pension Notes

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Mercer CFA World Pension Index 2021: evolution of the pension systems and the importance of private funded systems

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Executive Summary

The 2021 Mercer World Pension Index evaluates the pension systems of 43 countries, with Iceland, the Netherlands and Denmark being the best rated, and the Philippines, Argentina and Thailand the worst.

The Icelandic system is at the forefront, having a unique combination of public and private pensions, the latter with high coverage and contribution rates, so that even those workers with half the average salary receive a pension, with 71% coming from the private funded system.

The results for Latin American countries show that pensions are still a major challenge in the region. Chile ranks 16th, 67 points out of a possible 100 (index value), Uruguay ranks 20th with 60.7 points, Colombia 25th with 58.4 points, Peru 29th with 55 points, Brazil 30th with 54.7 points, Mexico 37th with 49 points and Argentina 42nd with 41.5 points.

It is worth mentioning that although Chile and Peru have allowed multiple fund withdrawals, reducing savings and pension amounts, Mexico has taken measures that seek to increase savings, such as the gradual increase in the contribution rate to the individual accounts system. This has resulted in an increase in Mexico's index value, from 44.7 to 49 points between 2020 and 2021, contrary to what happened in the case of Chile and Peru.

Likewise, the importance of private funded savings in the ranking of the Mercer index should be noted. Iceland, the Netherlands, and Denmark, the top three ranked countries, have savings from funded and private pension funds of more than 150% of their GDP. Pension systems such as those of Japan and Korea, on the other hand, are mainly PAYGO, so they have low levels of funded savings. These countries have a low index ranking.

I. Introduction

The COVID-19 health crisis continues to affect the well-being of millions of individuals worldwide. It is worth mentioning that it does not exclusively affect health systems or those who contract the virus. There are broader economic effects derived from higher public indebtedness and more restricted economic activity in several countries.

Older populations, lower interest rates and more uncertain future returns on investments have a potential negative impact on the financial well-being of future retirees. To avoid this impact, action must be taken now through ad-hoc pension reforms that take the long-term nature of pension savings into account.

The Mercer CFA Institute World Pension Index 2021 has recently been published. It includes 4 new pension systems not included in previous editions, namely Iceland, Taiwan, United Arab Emirates (UAE) and Uruguay. Thus, in this edition the pension systems of a total of 43 countries are compared with respect to their Adequacy (the benefits likely to be received), Sustainability (their ability to continue providing pensions despite economic and demographic pressures) and Integrity (degree of governance of the systems to generate trust in the community in the long term). These sub-indices weight 40%, 35% and 25% in the final result of the index, respectively.

The aforementioned index emphasizes the importance of private systems[1] in the design of pension systems worldwide, especially for their ability to pay sustainable pensions over time. As will be seen, these systems are significantly present in the countries best evaluated by the index.

[1] It must be pointed out that all private systems are funded, and mostly individually funded.

II. Results

II.1 General results

Table 1 shows the 2021 results of the Mercer index. Ratings range from A to E, with the best pension systems in the world being Iceland (included for the first time in this assessment), the Netherlands and Denmark. The most poorly evaluated pension systems, on the other hand, are the Philippines, Argentina and Thailand.

Iceland's pension system leads the pack, due to a number of good features that are highlighted in the Mercer report. In particular, the three pillars comprising the system:

- First pillar: public contributory PAYGO pension, relatively generous and focused on lower-income workers, not necessarily those who contributed. Financed with a contribution rate of 6.35% (employer).
- Second pillar: mandatory private occupational pensions, also mandatory for self-employed workers, with a minimum contribution rate of 12% of the worker's salary (the worker contributes 4 percentage points and the employer 8).
- Third pillar: voluntary private savings.

First pillar pension recipients may also qualify for a number of supplementary benefits[2].

As the Mercer report mentions, the success of the Icelandic system is explained by a unique combination of private and public pensions that largely prevents old-age poverty in the entire population. This is reflected in the fact that, according to the OECD[3], the gross replacement rate is 51.8% of the full-career salary for an average worker, paid exclusively by the private system; whereas for a worker earning half the average salary, the replacement rate rises to 72.9%, explained by the added benefit to the lower-income strata provided by the PAYGO pillar. Thus, these figures show that approximately 29% of the pensions of workers earning half the average salary is paid from the public PAYGO system, while the remaining 71% comes from their savings in the funded system.

[2] For example, there is a supplement for single people, a supplement for certain living expenses and a supplement for dependent children under 18 years of age.

[3] Source: Pensions at a Glance 2021, OECD. Table with gross replacement rates available at: https://stat.link/files/ca401ebd-en/uwc8nt.xlsx

Table 1. Summary of results from year 2021

Grade	Index Value	Systems	Description
A	>80	Iceland Netherlands Denmark	A first class and robust retirement income system that delivers good benefits, is sustainable and has a high level of integrity
B+	75-80	Israel Norway Australia	A system that has a sound structure, with many good features, but has some areas for improvement that differentiates it from an A-grade system
B	65-75	Finland Sweden United Kingdom Singapore Switzerland Canada Ireland Germany New Zealand Chile	
C+	60-65	Belgium Hong Kong SAR USA Uruguay France	A system that has some good features, but also has some major risks and/or shortcomings that should be addressed. Without these improvements, its efficacy and/or long-term sustainability can be questioned.
C	50-60	UAE Malaysia Spain Colombia Saudi Arabia Poland China Peru Brazil South Africa Italy Austria Taiwan Indonesia	

Source: 2021 Mercer CFA Institute World Pension Index.

Table 1. Summary of results from year 2021 – Continuation

Grade	Index Value	Systems	Description
D	35-50	Japan Mexico Korea (south) Turkey India Philippines Argentina Thailand	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 sustainability are in doubt.
E	<35	Nil	A poor system that may be in the early stages of development or non-existent.

Source: 2021 Mercer CFA Institute World Pension Index.

2. General recommendations

Each system reflects a unique reality. However, there are some common areas for improvement, as many of these systems will face similar issues for decades to come. There are a series of reforms that can be implemented to improve the long-term results of pension systems. According to Mercer's 2021 report, these reforms include:

- Increase the coverage of workers, including non-traditional jobs (GIG economy) and self-employed or independent workers.
- Raise the official retirement age to reflect increased life expectancy.
- Promote greater labor participation of older people.
- Promote higher levels of private savings, both inside and outside the pension system.
- Implement measures that reduce the pension gap between genders and other minorities.
- Reduce the flight of pension funds before retirement, thus ensuring that the funds saved, often with tax benefits, are used as a source of income in retirement.
- Review the updating of the parameters in the pension systems, to achieve the defined pension objectives.
- Improve the governance of private pension plans and introduce greater transparency to improve member confidence.

II.3 Results in Latin America

Table 2 shows the 2021 results for the Latin American countries considered in the Mercer report. They rank between 16th for Chile and 42nd for Argentina (penultimate place).

It is worth mentioning that since the 2021 edition of this report includes 4 new countries, the comparison of the Mercer index ranking between different years is not relevant. What must be considered is the variation in the index obtained. In this case, the rankings of Argentina, Colombia and Peru dropped; Brazil and Mexico rose; Chile remained unchanged, and Uruguay is being evaluated for the first time. The following must be taken into account regarding the value of the index obtained:

- Argentina.[4] In 2008, the individual accounts of workers, amounting to more than 31,000 million dollars (equivalent to 12% of GDP), were expropriated and transferred to a defined benefit PAYGO system. The system currently ranks 42nd, second-last, only ahead of Thailand.
- Chile.[5] There were three fund withdrawals between 2020 and 2021, involving a total disbursement of USD 49,706 million (29% of the funds that existed when the withdrawals began). Hence, men's balances decreased by 24.3% and those of woman by 33.3%, which will lead to a decrease in the replacement rate and a consequent drop in the Mercer index ranking in years to come, if steps are not taken to replenish these savings.
- Similarly, in Peru, multiple fund withdrawals were made in 2016, and then in the 2020-2021 period, due to the health crisis. The withdrawals totaled USD 27,151 million, 79.5% of the funds existing to April 2016, when they began. Peru ranks 29th, and the 2021 Mercer Index report warns about this situation, recommending that the country should: "reduce access to pension assets before retirement."
- In Mexico, on the other hand,[6] sound measures have been taken to increase savings. In January 2021, a series of reforms were approved, including: a gradual increase in the contribution rate to the individual accounts system, from 6.5% to 15%; and a reduction in the number of weeks of contributions for accessing a pension. The increase from 44.7 to 49 in the value of the index is, according to Mercer's 2021 report, a consequence of this reform.

[4] Further details in Pensions Note 57, by clicking here.

[5] Further details in Pensions Note 58, by clicking here.

[6] Further details in Pensions Note 54, by clicking here.

Table 2.- Ranking of the Mercer index, value of the index obtained and reason for the variation of the index in Latin American countries

Country	2021 Ranking	Index value		Reason for variation in the index value
		2020	2021	
Argentina	42nd	42.5	41.5	A reduction in home ownership and some data clarification in the adequacy sub-index
Brazil	30th	54.5	54.7	Increase in real economic growth levels
Chile	16th	67	67	The increase in the net replacement rate was offset by lower labor participation of older people
Colombia	25th	58.5	58.4	Drop in labor participation by older people
Mexico	37th	44.7	49	Increase in the net replacement rate as a result of the reforms approved in January 2021
Peru	29th	57.2	55	Drop in labor participation by older people
Uruguay	20th	-	60.7	-

Source: Based on MERCER CFA Institute's World Pension Index.

II.4 Recommendations to Latin American countries for improvement

The Mercer 2021 report's proposals for improvement for the Latin American countries considered in the study are the following:

Argentina: (i) Increase the coverage of workers in pension plans through automatic enrollment or participation; (ii) Introduce a minimum level of mandatory contributions to a retirement savings fund; (iii) Introduce a minimum age to access the benefits of private pension plans; (iv) Improve the regulatory requirements for the private pension system.

Brazil: (i) Increase the coverage of workers in occupational pension schemes through automatic enrollment or participation; (ii) Introduce a minimum level of mandatory contributions to a retirement savings fund; (iii) Introduce a minimum access age so that the benefits are preserved for retirement; (iv) Allow individuals to withdraw gradually while receiving part of the pension.

Chile: (i) Increase non-contributory support to the poorest senior citizens; (ii) Increase the retirement age for women; (iii) Introduce a minimum age for access to the benefits of the private system; (iv) The regulations must require pension plans to provide annual reports available to all their members.

Colombia: (i) Increase non-contributory support to the poorest senior citizens; (ii) Raise the level of household savings; (iii) Increase the level of coverage of workers in pension plans; (iv) Gradually increase the official retirement age; (v) Introduce agreements to protect the pension interests of both parties in a divorce.

Mexico: (i) Introduce a requirement that part of the benefits of private plans must be considered an income stream; (ii) Increase the level of contributions to the individual accounts system; (iii) Increase the rate of participation in the labor force of senior citizens; (iv) Improve governance requirements for the private pension system, including the need for minimum degrees of individual funding in defined benefit plans; (v) Improve the required level of communication with members of private pension plans.

Peru: (i) Introduce non-contributory support for the poorest senior citizens; (ii) Increase the coverage of workers in pension plans; (iii) Reduce access to pension assets before retirement; (iv) Allow individuals to gradually retire while receiving a partial pension; and (v) Improve governance requirements for the private pension system.

Uruguay: (i) Increase the minimum public pension for lower income individuals; (ii) Improve governance requirements for the private system; (iii) Raise the retirement age as life expectancy increases; (iv) Require part of the benefits to be considered an income stream.

III. Importance of the private systems in the results

The Mercer World Pension Index uses three sub-indices to assess how well-prepared pension systems are worldwide: Adequacy, Sustainability and Integrity, which, as previously mentioned, weight 40%, 35% and 25% in the final result, respectively. Each one of these sub-indices has special considerations regarding private pension systems:

Adequacy

This subindex considers the level of income provided by each system, as well as the net replacement rate. A critical element for providing adequate benefits is the design of the private pension system. The following are specifically considered: (i) Are voluntary contributions to private plans treated more favorably in tax terms than similar savings in a bank account?; (ii) Is there a minimum access age for receiving benefits from private pension plans?; (iii) After resignation, can full access to accumulated benefits be obtained and can they be transferred to another private pension plan?; (iv) What proportion of benefits must be considered an income stream and not a lump sum?; (v) After divorce or separation, are pension savings considered in the distribution of assets?; (vi) Is it mandatory for individuals to continue saving if they receive income support?

Sustainability

Regarding the importance of the sustainability of pension systems, the Mercer report cites the World Bank: “Most public systems[7] are not financially viable and cannot keep their promises to the younger generations who will retire in the future”.

Hence, the sustainability sub-index considers the contribution rate, the level of pension savings and coverage in the private pension system.

It is worth mentioning that indicators such as the level of fiscal debt and public spending on pensions are also considered.

Integrity

The third sub-index considers the integrity of the pension system, with a focus on savings

[7] Referring to contributory public PAYGO systems.

schemes, which normally exist in the private sector. With most systems incorporating private pensions playing an increasingly important role in providing benefits, it is critical for the community to trust the private systems.

Hence, the system considers the role of regulation, governance and the level of protection for members, depending on the different risks, as well as communication with members.

III.1 Relationship between the level of savings provided by the funded system and the value of the Mercer index

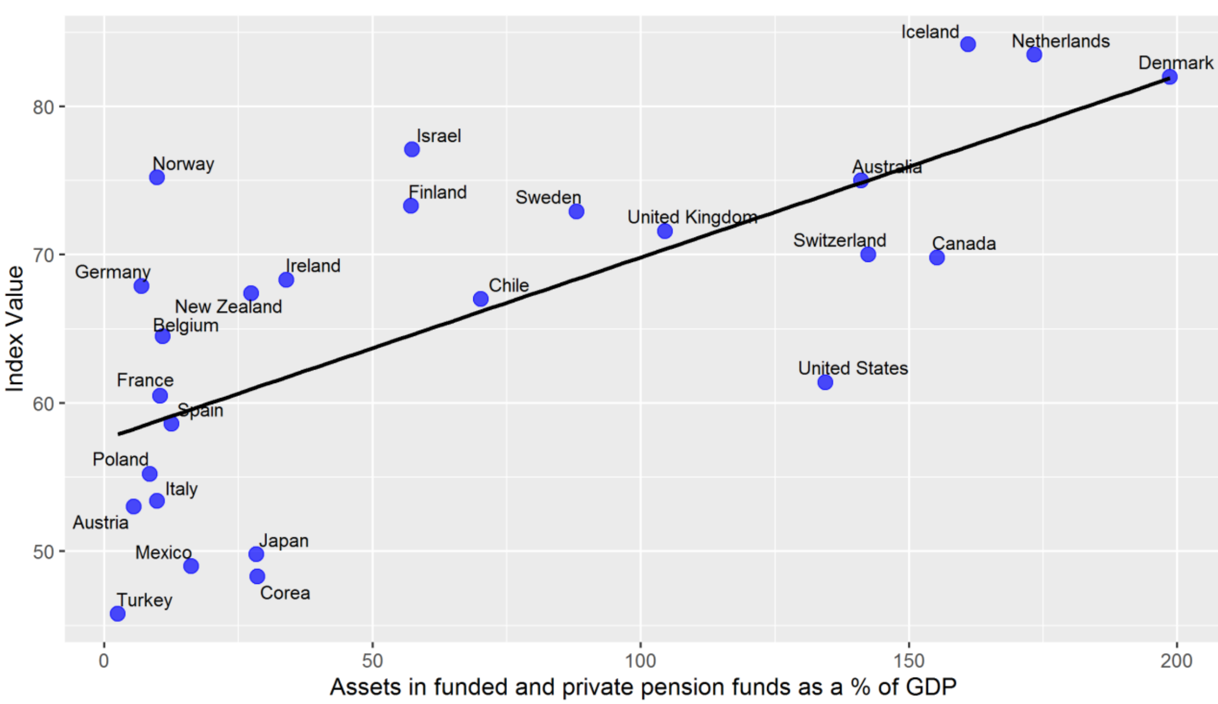
The contents of the previous section evidence the importance of private, and therefore funded systems, in the results of the Mercer index. Thus, it is not surprising that the countries with the highest percentage of funded and private savings vs. GDP have the highest values of the index and rank ahead of the others, as shown in Graph 1.

As we know, Iceland, the Netherlands and Denmark lead the ranking, as the countries with the highest value in the index, and they also have very high levels of funded and private pension savings vs. GDP (over 150% of GDP; they are on the right-hand side of the graph).

Pension systems such as those of Japan and Korea, on the other hand, are mainly PAYGO systems, so they have low levels of funded savings. These countries have a low index ranking. The Mercer report suggests that Japan should reduce the level of public debt and that Korea should increase the contribution rate to the individually funded systems.

It is worth mentioning that after the recent pension reform in Mexico, the level of funded savings vs. GDP will grow notably in the future, so that its replacement rate and index ranking should increase. This was discussed in greater detail in section II.3.

Graph 1.- Relationship between assets in funded and private pension funds and Mercer index value



Source: Jointly drawn up by FIAP, Mercer CFA Institute Global Pension Index 2021 Report and Pensions at a Glance 2019 (OECD). Since the information is obtained from the OECD, the countries in the graph are those with available information, and not to all those considered in the Mercer report.

Conclusions

The Mercer CFA Institute World Pension Index continues to be a very useful tool for evaluating, comparing and improving pension systems worldwide. The periodic update of the reports enables monitoring the different countries and analyzing good practices in pension matters.

The results for the Latin American countries were dissimilar: Argentina, Colombia and Peru suffered drops in their index, Brazil and Mexico rose, and Chile remained unchanged. While Peru and Chile allowed fund withdrawals and lowered their replacement rates, negatively affecting their ranking in the new versions of the index, Mexico made reforms to increase individual savings. Mexico should be an example for the rest of the countries.

The evidence also highlights the importance of the private (funded/individually funded) pension systems for the sustainability of the systems and, therefore, the value of the final index they obtain. The three best evaluated systems are Iceland, the Netherlands and Denmark, which have large levels of funded and private savings as a percentage of GDP.

Queries: International Federation of Pension Fund Administrators (FIAP).
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