COLUMBIA THREADNEEDLE INVESTMENTS

Your success. Our priority.

PENSIONS WATCH – ISSUE 2: WHAT'S BEEN HAPPENING AND WHAT'S ON THE HORIZON IN THE WORLD OF PENSIONS

Chris Wagstaff, Head of Pensions and Investment Education, Columbia Threadneedle Investments and Senior Visiting Fellow, Finance Faculty, the Business School (formerly Cass), London

This month we focus on why the UK pensions system is, according to one influential study, in the doldrums and how to propel it up the global league table…

Better to go Dutch if you want a first class pensions system

At school I was frequently reminded that being graded a C+ meant I could do better – a *lot* better. However, in some subjects, try as I might C+ was seemingly as good as it was ever going to get. The UK pensions system has found itself in a similar position, with the authoritative annual Mercer CFA Institute Global Pension Index Report[1] having rated it a C+ every year since 2016, against its 50 adequacy, sustainability and integrity factors. Now in its 12th year, the Report has consistently applied these factors to rate system design, pension coverage, contribution levels, demographics, economic stability, access to growth assets, regulation, governance, trust, transparency and communication.

Of the 39 retirement systems the Report rates on a scale of A to D (covering almost two-thirds of the world's working population), only the Netherlands and Denmark have been consistently awarded the much-coveted A-grade, with the Netherlands achieving the top spot in 2020. Other European countries which ranked ahead of the UK this year, albeit with a B- grade, were (in descending order): Finland; Sweden; Norway; Germany; Switzerland; and Ireland, just. That said, of the G7, the US, France, Italy and Japan all ranked below the UK, with latter being graded a lowly D.

However, while pensions systems across the world may be as disparate as the people they serve, without exception they all have one thing in common: they are under pressure. Globally, people are living longer, while fertility rates decline. Moreover, recent sub-par global economic conditions, which will likely result in a further prolonged period of historically low (even negative) interest rates and modest investment returns, has added further complexity to the conundrum. Alongside this is the shift from collective passivity to individual responsibility, as State and employer paternalism cedes to savers increasingly taking a great deal more personal responsibility for their retirement and financial futures. Taking all this together, you have a situation where governments worldwide are grappling with the problem of how to engineer pension systems that are both sustainable and equitable for current and future generations of retirees. Of course, some countries have better prepared for this than others, while many of the others continue to buckle under the strain.

So how might the UK's position be improved?

Assuming 15th place in the Index, one notch down on 2019, the UK scores highly for integrity (or, more accurately, security) but falls down on adequacy and sustainability, meaning the UK is a long way from having the ability to consistently achieve good retirement outcomes.

The Report pinpoints the problem as, "too much focus [having been placed] on security at the expense of adequacy and affordability… leaving pensions savers with low investment returns" and helpfully suggests, "increasing access to growth assets, [so as] to improve the sustainability of the system, support the economy, and increase the potential for achieving better outcomes for pension savers." It also points out that "the pandemic has put into sharp focus the flaws within the UK pensions system" citing "employers' part in both supporting the workforce and helping them accumulate and secure wealth… becoming increasingly important…" with some "starting to mitigate future risks and looking to improve member outcomes by outsourcing elements of their traditional responsibilities."

[1] See: Mercer (2020), Mercer CFA Institute Global Pension Index, Mercer, Melbourne.

So what else does the UK need to do if it is to move from mid-table obscurity in securing better retirement outcomes? One need look no further than the A-graders whose pension systems are underpinned by:

- Promoting higher older age labour force participation;
- Well-structured three-pillar pension systems (state, occupational and private) with clear and simple rules forged through political and stakeholder consensus;
- Pension-saving being seen as the social norm;
- High quasi-mandatory contribution rates and near universal coverage, and
- Pension assets far in excess of 100+% of GDP which lessen inter-generational inequality.

Moreover, the Netherlands and Denmark haven't succumbed to the temptation of many governments during the pandemic of allowing temporary access to accrued pensions or temporarily reducing the level of compulsory contribution rates, which will likely have a longer-term material impact on the adequacy, sustainability and integrity of pension systems.

Now although the UK government has its work cut out in creating a pensions system which would propel it to the top of the world rankings, it isn't inconceivable to believe that the UK will, in time, be able to genuinely claim to offer world-class retirements to the masses. Indeed, the Report itself gives the UK some valuable pointers to how to potentially secure a B- grade (which it was last awarded in 2015), in a reasonably short timeframe. These pointers include:

- Further increasing pension scheme coverage among both the employed and self-employed;
- Increasing the level of contributions to occupational and private pensions;
- Improving access to (illiquid) growth assets;
- Reducing the gender pensions gap;
- Regularising member communications and retirement income projections;
- Raising the level of household saving and reducing the level of household debt;
- Increasing the State Pension age (SPa) over time
- Raising the minimum pension for low income pensioners, and
- Restoring the requirement to take retirement savings as an income stream, rather than as one or a series of lump sums under freedom and choice.

So why does all of this matter?

Pension savers are increasingly reliant on their DC pension pots to secure a standard of living in retirement akin to that which they enjoyed during their working lives. Therefore, if left unaddressed, a shortfall in private pension coverage, insufficient pension contributions, restricted access to illiquid assets and failing to respond to increased longevity could conspire to unseat retirement outcomes and take the UK beyond an avoidable tipping point.

Of course the UK has, through regulatory initiatives and government legislation, been addressing scheme coverage and contribution rates, governance shortcomings, inadequate retirement income projections and increases in the SPa. However, if good retirement outcomes are to become the norm, we need to think about widening auto-enrolment eligibility, introducing the auto-escalation of contributions, facilitating investment in infrastructure, accelerating scheme consolidation and the introduction of pension dashboards.

To draw on the words of Dr David Knox, the Report's lead author, "Covid-19 has exacerbated retirement insecurity and governments need to use this as an opportunity to examine their system inadequacies and make improvements."

Issued 11.20 | Valid to 11.21 | J31072 | 3314463