COLUMBIA THREADNEEDLE INVESTMENTS

Your success. Our priority.

PENSIONS WATCH – ISSUE 14: WHAT'S BEEN HAPPENING AND WHAT'S ON THE HORIZON IN THE WORLD OF PENSIONS

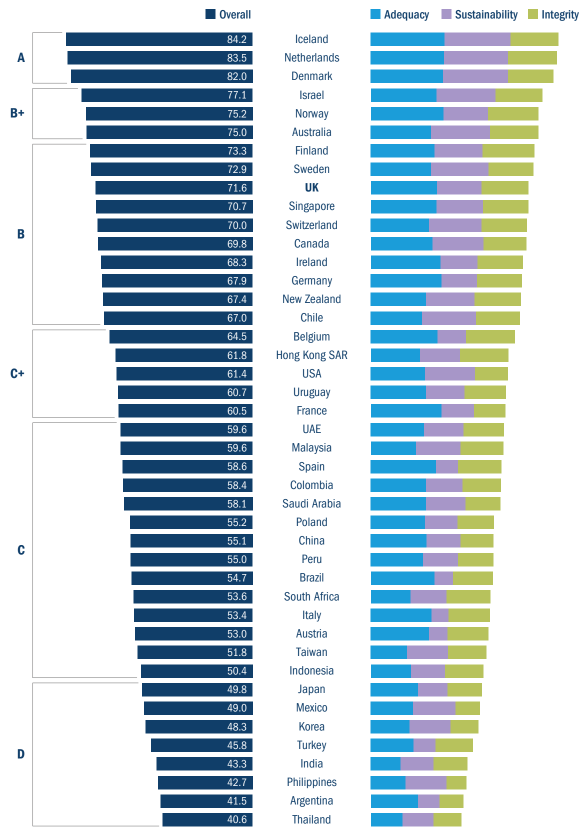
Chris Wagstaff, Head of Pensions and Investment Education, Columbia Threadneedle Investments and Senior Visiting Fellow, Finance Faculty, Bayes Business School, City University, London

In Pensions Watch edition 5 (January 2021), we predicted that 2021 could be the year that the UK pension system was propelled up the global rankings, from its lowly and long-standing C+ rating, by the influential annual Mercer CFA Institute Global Pension Index.[1] Now awarded a prestigious B-grade, for the first time since 2015,[2] we look at what motivated this upgrade and what remains to be achieved if the UK is to join the A-listers.

The backdrop to the UK's upgrade

The 13th annual edition of the *Mercer CFA Institute Global Pension Index Report*[3] (the Report) is the most comprehensive version yet, of this closely followed publication. Employing an A to D framework, calibrated on a scale of 0 to 100, to independently evaluate 43 pension systems against more than 50 adequacy, sustainability and integrity (or, more accurately, security) factors, the influential report covers almost two-thirds of the world's population.[4]

Figure 1: Mercer CFA Institute Global Pension Index Report 2021 results



Source: Mercer (2021) Highlights Report p.2 and Mercer (2021) p.6 (extracts).

[1] https://www.columbiathreadneedle.co.uk/uploads/2021/02/a383f73ec62490784b1699b329854fff/pensions-watch_issue-5.pdf. This came on the back of coverage in Pensions Watch edition 2 (November 2020), which focused on why the UK pension system was, according to the Mercer CFA Institute Global Pension Index Report 2020, somewhat in the doldrums.
[2] A B-grade is awarded on the basis of "a sound structure, with many good features, but has some areas for improvement that differentiates it from an A-grade system."
[3] Mercer (2021), Mercer CFA Institute Global Pension Index. Available at: www.mercer.com/globalpensionindex
[4] The 2021 Report welcomed four new entrants – Iceland, Taiwan, UAE and Uruguay – to its pension scheme universe.

As *Figure 1* shows, the coveted A-grade, which signifies "sustainable and well-governed systems, providing strong benefits to individuals" was, once again, awarded to the Netherlands and Denmark, though with the top spot this time being taken by, newcomer, Iceland. However, it was the UK's, three pillar, pensions system which, in being awarded a B-grade, registered the biggest improvement of the 43 systems, jumping from 15th place in 2020 with a C+, to 9th in 2021, recording its highest-ever score of 71.6.[5]

Figure 2: The UK now scores highly for both adequacy and integrity but still not sustainability

	Adequacy			Sustainability			Integrity			Overall		
	Score (0-100)	Grade (A-D)	Position	Score (0-100)	Grade (A-D)	Position	Score (0-100)	Grade (A-D)	Position	Score (0-100)	Grade (A-D)	Position
UK 2021	73.9	B	9/43	59.8	C	14/43	84.4	A	8/43	71.6	B	9/43
2021 average	62.2			51.7			72.1			61.0		
UK 2020	59.2	C	24/39	58.0	C	14/39	83.7	A	8/39	64.9	C+	15/39
2020 average	60.8			50.0			71.3			59.7		

Source: Mercer (2021) Extracts from Table 3 p.7, Table 4 p.16 and p.48. Mercer (2020) Extracts from Table 2 p.7, Table 3 p.8 and p.45.

As *Figure 2* shows, the UK's strong overall showing was supported by yet another solid integrity score, bolstered by a dramatic improvement in its adequacy credentials but was, once again, tempered by continued weakness in its sustainability rating.[6]

This bounce back was ultimately attributable to two main factors. Firstly, the UK pension system's adequacy score was given a welcome shot in the arm by a projected increase in future net income replacement rates.[7] This stemmed from a combination of the State Pension age (SPa) increasing, in October 2020, from 65 to 66, thereby lengthening the term many people will spend in the workforce contributing to their pensions, continually improving auto enrolment (AE) coverage and the increase, from 5% to 8% in April 2019, in the minimum AE contribution rate feeding through to pension pot sizes. Secondly, the UK system's integrity rating was given a boost by the Pension Schemes Act 2021 introducing measures that permit a redistribution of risk between employers and members,[8] notably allowing Collective Defined Contribution (CDC) schemes to operate, and providing yet more protection to pension savers by extending The Pension Regulator's (TPR's) powers and access to information.

But there's still work to be done

However, as in 2020, this year's Report suggests that the UK's overall index score could be further improved by implementing four measures.

Firstly, by further extending the coverage of employees and the self-employed in private pension schemes, to reduce dependence on the state pension.[9] Indeed, as we noted in Pensions Watch edition 12 (September 2021), despite 10.5m people having been auto enrolled into an occupational pension scheme since 2012 and almost 1m re-enrolled, a not insignificant 10.1m of the UK's employed population are now ineligible for AE as a result of their age and/or level of earnings – with a disproportionate number of these being women.[10] Indeed, the Report notes that the UK has the 4th largest gender pension gap of the 43 pensions systems analysed.[11] Moreover, few of the nation's 4.4m self-employed, who are also excluded from AE, have any notable pension provision.[12]

Secondly, given the Report's long-held belief that the fundamental basis of any pension system is to provide a secure income stream throughout retirement, the Report recommends that the UK ensures that at least 60% of accumulated retirement benefits are taken as an annuity. However, this comes at a time when, post freedom and choice, annuitisation in the UK has hit an all time low.[13]

Finally, the Report suggests that the UK raises the minimum pension, or the *pension credit* top up, for low-income pensioners[14] and for households, in general, to reduce their indebtedness.[15] Interestingly, unlike in 2020, the Report doesn't mention the need to further increase the minimum AE contribution rate, despite widespread industry calls to do so.

[5] Adding a cautionary note, the Report acknowledges that 2021 index values do not yet fully recognise the longer-term effects of the COVID-19 pandemic on future pension payments.
[6] The Adequacy score (40% of the index) is dominated by the replacement rate of the state pension for the average earner, the preservation of its real value and net (after-tax) replacement rates more generally for a range of after-tax pre-retirement income levels. (Net replacement rates measure how effectively a pension system replaces an after-tax pre-retirement income with an after-tax retirement income across a range of pre-retirement income levels).
The Sustainability score (35% of the index) is principally driven by the pension system's coverage of the employed and self-employed, pension assets as a percentage of GDP and demographics – notably the old age dependency ratio (the ratio of a country's dependent population to its total working-age (those aged 15-64) population. The Integrity score (25% of the index) is underpinned by the quality and coverage of the system's regulation, governance, communications and transparency.
[7] Net replacement rates measure how effectively a pension system replaces an after-tax pre-retirement income with an after-tax retirement income across a range of after-tax pre-retirement income levels. The Report had exclusive access to updated, albeit unpublished, OECD data on net replacement rates.
[8] As the regulation of Superfunds and commercial consolidators (these target closed Defined Benefit schemes seeking to reduce costs and manage liabilities and risks where buy-out with an insurer is an unobtainable goal in the near term) was absent from the Pension Scheme Act 2021, each continues to operate under TPR's interim regulatory regime, introduced in June 2020.
[9] Pensions Watch edition 8 (May 2021) considers why the state pension might increasingly become the mainstay of most retirement outcomes. See: https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-8/
[10] All data is as at 30 June 2021. See: https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-12/
[11] Mercer (2021) Report Highlights. p.4. The gender pension gap is the difference between the pensions of men and women at age 65 as a percentage of men's pensions.
[12] Pensions Watch edition 12 (September 2021).
[13] Pensions Watch edition 12 (September 2021).
[14] Those of SPa with a weekly income below £177.10 (single person) or £270.30 (couple) are eligible for *pension credit* to top up their income to these levels.
[15] In Q2 2021, household debt was 130.5% of household disposable income, having peaked in Q2 2008 at 151.5%. Source: Household Debt: Key Economic Indicators. House of Commons Library. 7 October 2021.

Suffice to say, the UK is not alone in still having work to do, as even the A-listers – Iceland, the Netherlands and Denmark – have yet to achieve pension perfection.[16] Indeed, the Report notes that, “There continues to be a range of reforms that can be implemented to improve the long-term outcomes from retirement income systems.”[17]

Why does this matter?

> *“Despite the challenges, now is not the time to put the brakes on pension reform – in fact, it’s time to accelerate it. Individuals are having to take more and more responsibility for their own retirement income, and they need strong regulation and governance to be supported and protected.”*
>
> **Dr David Knox,**
> **Lead Author of the 2021 Mercer CFA Institute Global Pension Index[18]**

While, against the backdrop of secular demographic headwinds, mounting environmental, social and governance (ESG) risks and acute macroeconomic challenges, pension perfection is hard to achieve, continued reform is needed if good retirement outcomes are to become the norm. Indeed, as the Report acknowledges, “There is no perfect pension system that can be applied universally, but there are many common goals that can be shared for better outcomes.”[19]

With this in mind, and as noted in recent editions of Pensions Watch,[20] there is still much to do if the UK pension system is to be put on a more secure footing, akin to that of the A-listers. Of course, advancing the UK’s sustainability score, in particular, will be key to generating consistently good retirement outcomes. That said, the direction of travel is certainly positive, with momentum building around widening auto-enrolment eligibility (ultimately resulting in greater inclusion of the disenfranchised and a narrowing of the gender pension gap), the forthcoming simplification of annual pension benefit statements, the imminent testing of the pension dashboard (the launch of each resulting in prospectively greater pension saver engagement), not to mention fiduciaries’ compliance with ever more stringent ESG regulations (prospectively leading to more sustainable outcomes).[21]

So while several key challenges have already been overcome, evidenced by the UK’s elevation to a prestigious B-grade, other, equally complex, challenges must continue to be addressed if the UK is to secure consistently good retirement outcomes and ultimately achieve a coveted A-grade.

[16] Although scoring straight-As across the board, Iceland, the Netherlands and Denmark, in being awarded overall scores, of out of 100, of 84.2, 83.5 and 82.0, still have progress to make in a number of areas. See Mercer (2021) op.cit. pp.32, 35 and 40.
[17] Mercer (2021) op.cit. p.8. As the Report notes, these include: 1. increasing the coverage of employees (including non-standard workers) and the self-employed in the private pension system, recognising that many individuals will not save for the future without an element of compulsion or automatic enrolment; 2. increasing the SPa and/or retirement age to reflect increasing life expectancy; 3. promoting higher labour force participation at older ages, which will increase the savings available for retirement and limit the continuing increase in the length of retirement; 4. encouraging higher levels of private saving, both within and beyond the pension system, to reduce the future dependence on the public pension; 5. introducing measures to reduce the gender pension gap and those that exist for minority groups ensuring that the funds saved are used for the provision of retirement income; 6. ensuring that the real value of public pensions is maintained, balanced by its long-term sustainability, and 7. improving the governance of private pension plans and introducing greater transparency to improve the confidence of plan members.
[18] Mercer (2021) Report Highlights. p.3.
[19] Mercer (2021) op.cit.p5. These common goals (of which those already met by the UK are italicised) comprise:
Adequacy. 1. A minimum pension is provided to the poorest pensioners that represents a reasonable percentage of average earnings in the community. 2. At least a 70% net (after-tax) replacement rate at retirement for a full-time worker on a median income. 3. At least 60% of accumulated retirement benefits to be taken as an income stream.
Sustainability. 1. At least 80% of the working age population should be members of private pension plans. 2. *Current pension fund assets should be more than 100% of GDP to fund future pension liabilities.* 3. Labour force participation rate for those aged 55-64 should be at least 80%.
Integrity. 1. *A strong prudential regulator supervising private pension plans.* 2. *Regular member communications including the provision of personal statements, projected retirement income and an annual report.* 3. Clear funding requirements for both defined benefit and defined contribution schemes.
[20] See: https://www.columbiathreadneedle.co.uk/en/inst/insights/?ksys-smart-filters=kurtosys-engine/insights&_tax_query_category[]=351
[21] Curiously, the Report only applies a 2% weighting within the Sustainability index to whether fiduciaries take ESG considerations into account within their investment policies, although the UK scores maximum points here.
See: Mercer (2021) op. cit. p.89.

To find out more visit columbiathreadneedle.com

Issued 11.21 | Valid to 12.21 | J31946 | 3905254