

**INTELLIGENT THINKING**  
**WHAT CONSTITUTES A FIRST CLASS**  
**PENSION SYSTEM?**  
**ADOPTING A GLOBAL PERSPECTIVE OF WHAT**  
**DEFINES A GOOD RETIREMENT OUTCOME**



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# WHAT CONSTITUTES A FIRST CLASS PENSION SYSTEM? ADOPTING A GLOBAL PERSPECTIVE OF WHAT DEFINES A GOOD RETIREMENT OUTCOME

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*“There is no long term view as to what a proper pension system should look like and this is something that the industry needs to get involved with as well as government. Many may feel that we have left it too late, but we can still make change happen.”*

**Professor Robin Ellison**  
Partner, Pinsent Masons

## EXECUTIVE SUMMARY

This paper takes a comprehensive look at pension systems worldwide and the factors which contribute to that all-important holy grail: generating a comfortable retirement for savers.

However, there are considerable challenges. Indeed, pension systems across the world may be as disparate as the people they serve, but they all have one thing in common. They are under pressure.

All over the world, people are living for longer.

As longevity consultancy Club Vita points out, in the UK the likelihood of dying between 65 and 75 has halved over the lifetime of someone born in the UK in 1949.<sup>1</sup>

Although rates vary from region to region, overall, there is a pronounced upward trend in life expectancy across the world, too. According to data from the World Bank, the average life expectancy globally in 2006 was just under 70; in 2014 it was 72.<sup>2</sup>

However, while we are living for longer, the level of pension provision isn't keeping pace. Of course, some countries have better prepared for this than others. Indeed, some retirement systems have been reformed to bear the added weight of the extra years while others are buckling under the strain.

So where does the UK fit in? The government and regulators have made significant strides to improve the system in recent years though it has been a long time coming. In 2005, the Turner Commission's central two recommendations were the introduction of auto-enrolment and simplification of the state pension. Both of these goals have now largely been achieved. Yet the UK government has taken a dramatically different ideological direction with the introduction, in April 2015, of pension freedom and choice, whereby retirees are no longer compelled to annuitise their pension pots. This we will discuss in relation to other countries throughout this paper.

Other challenges remain. The UK population is not saving enough for its retirement, despite auto-enrolment being successful so far. We look at how technology and the harnessing of behavioural techniques to engage people will help to close the gap. We also highlight the inequalities that exist in the current system – the intergenerational and gender gaps that remain, not to mention those social groups disenfranchised from and under-represented in the current system – and how these should be addressed.

<sup>1</sup> Why do people underestimate their longevity? Douglas Anderson, Club Vita. International Longevity Centre UK, 25 April 2016.

<sup>2</sup> Source: World Bank Indicators, Life expectancy at birth, total (years): <http://data.worldbank.org/indicator/SP.DYN.LE00.IN/countries?display=graph>

## CHAPTER ONE

In chapter one, we deconstruct the success of countries which received an 'A' grade in the Melbourne Mercer Global Pensions Index 2015 (MMGPI).<sup>3</sup> What do Denmark and the Netherlands have in common?

The two countries demonstrate that there are no short cuts to excellence. Simplicity and generosity are the hallmarks of both governments' approaches to pensions provision. Both countries boast multi-pillar systems with consistently robust contribution structures. In addition, few are disenfranchised from saving. For instance, in Denmark, unemployment insurance not only covers the country's compulsory second pillar workplace contributions, but it pays them at a double rate.

Political consensus and a collaborative approach to working with key stakeholders is another distinguishing feature of great pensions systems worldwide. Australia introduced compulsory superannuation with the support of its trade unions, while the Dutch have a culture of collaboration and co-operation.

We also examine the UK experience and how its individualistic society differs from the more inclusive cultures of Denmark and the Netherlands. Indeed, the MMGPI downgraded the UK's pensions system from a B plus to a B as a result of the government's decision to introduce freedom and choice at and in retirement.

## CHAPTER TWO

In chapter two, we focus on the factors which contribute to good pension outcomes, such as starting to save early, as exemplified by the Australian system. In Australia saving starts as soon as people enter the workplace.

We also examine ideal replacement rates: which are the countries with the best replacement rates and how did they get there? The UK is a long way from achieving those ideal replacement rates; we examine the idea of compelling people to save, versus using behavioural interventions. While compulsion achieves the best replacement rates, behavioural interventions are less proven but have considerable potential to do similarly.

## CHAPTER THREE

In chapter three, we look at the societal, demographic and economic factors which can lead to a poor retirement outcome. The financial crisis put many retirement systems worldwide under strain and led consumers to question many fundamental aspects of their retirement savings infrastructures. We hone in on the related challenges of ageing populations, poor investment returns and the new norm of sub-par economic conditions.

There are no easy solutions to these problems and savers are likely to have to come to terms with working and saving more for longer. However, the advent of part-time work, facilitated by technology, will help to smooth the transition into retirement for many. Equally, governments have a role to play in ensuring people are not disenfranchised from savings systems. We hone in on the UK example and the fact that the current system further disadvantages already under-pensioned groups.

Rebuilding trust in the system in the wake of the financial crisis is another challenge which most governments face. The finance industry is rated the least trustworthy in PR firm Edelman's annual survey of trust. We look at one UK pension scheme's approach to rebuilding trust in some detail, concluding that only by being consistently clear, honest and transparent will we succeed.

<sup>3</sup> Mercer (2015), Melbourne Mercer Global Pension Index, Australia Centre for Financial Studies, Melbourne.

## CHAPTER FOUR

In chapter four we shine a spotlight on pension reforms as governments around the world seek to walk the tightrope of creating pension systems that are both affordable to the state, corporate sponsors and individuals while able to sustain retirees through their twilight years.

## CONCLUSIONS AND RECOMMENDATIONS

Finally, we conclude by considering those enduring principles with universal application that characterise an ideal pensions system, acknowledging that there is no one-size-fits-all solution. We also examine the remaining challenges for the UK, and make some recommendations on how to improve the adequacy and sustainability of the pensions system.

# CHAPTER 1:

## GREAT DANES: WHAT CONSTITUTES A FIRST CLASS PENSIONS SYSTEM?

### KEY POINTS

- Governments need to:
  - increase the state pension age while encouraging greater levels of older age labour force participation;
  - encourage higher levels of private saving and ensure that pensions coverage is sufficiently widespread;
- Three factors underpin the best pensions systems: adequacy, sustainability and integrity.
- The pension systems in Denmark and the Netherlands are underpinned by:
  - higher than average employment rates of those aged 55 to 64;
  - well structured three pillar pension systems with clear and simple rules forged through political and stakeholder consensus;
  - a commitment to pension saving seen as the social norm;
  - high quasi-mandatory contribution rates and near universal coverage, and
  - pension assets of 160+% of GDP which lessen inter-generational inequality.

### THE CHALLENGES

Pensions systems across the world may be as disparate as the people they serve, but they all have one thing in common. They are under pressure.

As people live for longer and fertility rates decline, governments worldwide are considering how to engineer pension systems that are both sustainable and equitable for current and future generations of retirees.

Moreover, sub-par global economic conditions, resulting in a prolonged period of historically low (even negative) interest rates and modest investment returns, has added further complexity to the conundrum. This has culminated most visibly in the deterioration of defined benefit (DB) schemes' funding levels.

Indeed, the combination of these two seemingly secular demographic and economic trends has resulted in a shift from collective passivity to individual responsibility, as state and employer paternalism cedes to an environment where people will have to take a great deal more personal responsibility for their retirement and financial futures more generally.

While, as we note throughout the paper, there is no such thing as a perfect pensions system, as the Organisation for Economic Co-operation and Development (OECD) indicated in 2012<sup>4</sup> there is room for improvement in all countries' retirement-income provision. Perhaps unsurprisingly, as the 2015 edition of the annual Melbourne Mercer Global Pension Index (MMGPI) 2015 notes,<sup>5</sup> this is principally a consequence of countries facing a number of common challenges. The first is the need to increase the state pension age while encouraging greater levels of older age labour force participation in order to keep pace with improvements in life expectancy and to limit lengthening periods in retirement, which is increasingly becoming unaffordable.<sup>6</sup> For many, faced with working for longer, this will be an unpalatable proposition, and possibly unworkable in those countries and regions where health longevity continues to lag longevity improvements.

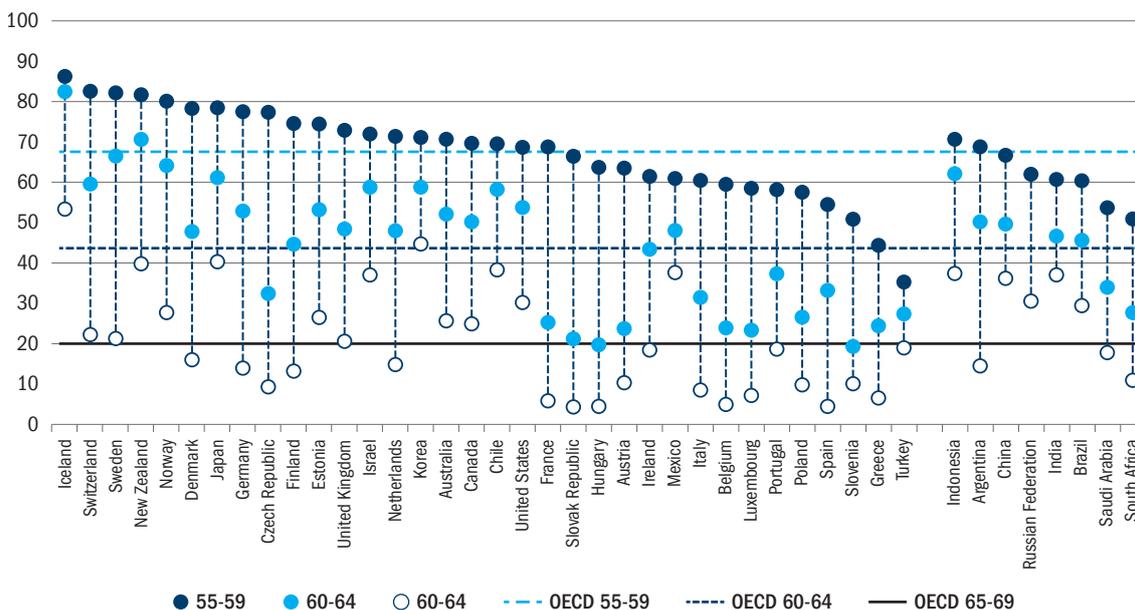
<sup>4</sup> OECD (2012), *OECD Pensions Outlook 2012*, OECD Publishing. <http://dx.doi.org/10.1787/9789264169401-en>.

<sup>5</sup> Mercer (2015), *Melbourne Mercer Global Pension Index*, Australia Centre for Financial Studies, Melbourne, Preface p3.

<sup>6</sup> OECD (2015), *Pensions at a Glance 2015: OECD and G20 indicators*, OECD Publishing, Paris. [http://dx.doi.org/10.1787/pension\\_glance-2015-en](http://dx.doi.org/10.1787/pension_glance-2015-en). According to the OECD p164, "in 1970 men in the OECD countries spent on average 11 years in retirement and women 15. By 2014 this had increased to 18.5 and 22.7 years respectively.

As the OECD chart below illustrates, higher older age employment rates are becoming the new reality across the world. Indeed, employment rates of those aged 55-64 have improved markedly over the past decade for most of the OECD, from 48% in 2004 to 56% in 2014, with the average age of those exiting the labour market now being 64.6 for men and 63.1 for women, though the employment rate continues to fall with age. As we note shortly below, the MMGPI targets an employment participation rate among those aged 55-64 of 65+%. However, some countries have considerably lower employment rates among older people than others, Turkey, for instance. This poses sustainability challenges to such countries' pensions systems, especially where, as mentioned above, health longevity lags longevity improvements, potentially creating significant financial strain among those who need care but cannot afford it.

**Chart 1.1: Employment rates of workers aged 55 to 69 (2014)**



Source: OECD (2015), Chart 7.6, p160. Data as at end-2014.

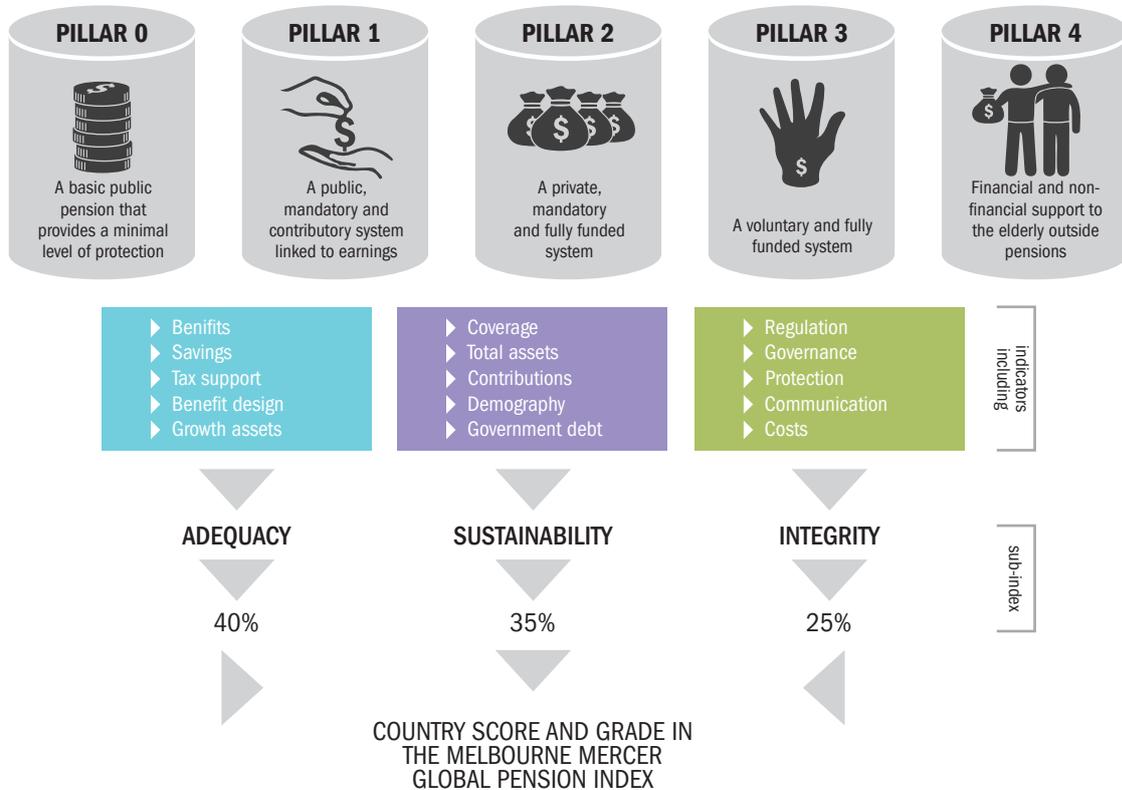
The second challenge is the need to encourage higher levels of private saving, leading to growth in the accumulation of private pension assets, to reduce pressure on stretched public finances.

The third is to make sure that pensions coverage is sufficiently widespread, covering under-pensioned groups like the self-employed.

Other challenges include: ensuring that people use pension savings for their intended purpose of generating a sustainable income stream throughout retirement, instead of engaging in unsustainable discretionary spending and depleting their pension pots at an early stage of retirement; ensuring that the indexation of state pension benefits are preserved but remain sustainable; and that the governance of private pension schemes is robust and transparent and overseen by a strong prudential regulator.

## WHAT FACTORS UNDERPIN A (NEAR) PERFECT PENSIONS SYSTEM?

Figure 1.1: The Melbourne Mercer Global Pensions Index (MMGPI)



Source: Mercer (2015), Infographic p2.

According to the MMGPI, three factors underpin the best pensions systems.<sup>7</sup> These are adequacy, sustainability and integrity. Adequacy is the first pillar of any successful pensions system. The index considers adequacy in the round, measuring benefits, savings, tax support, benefit design and growth assets.

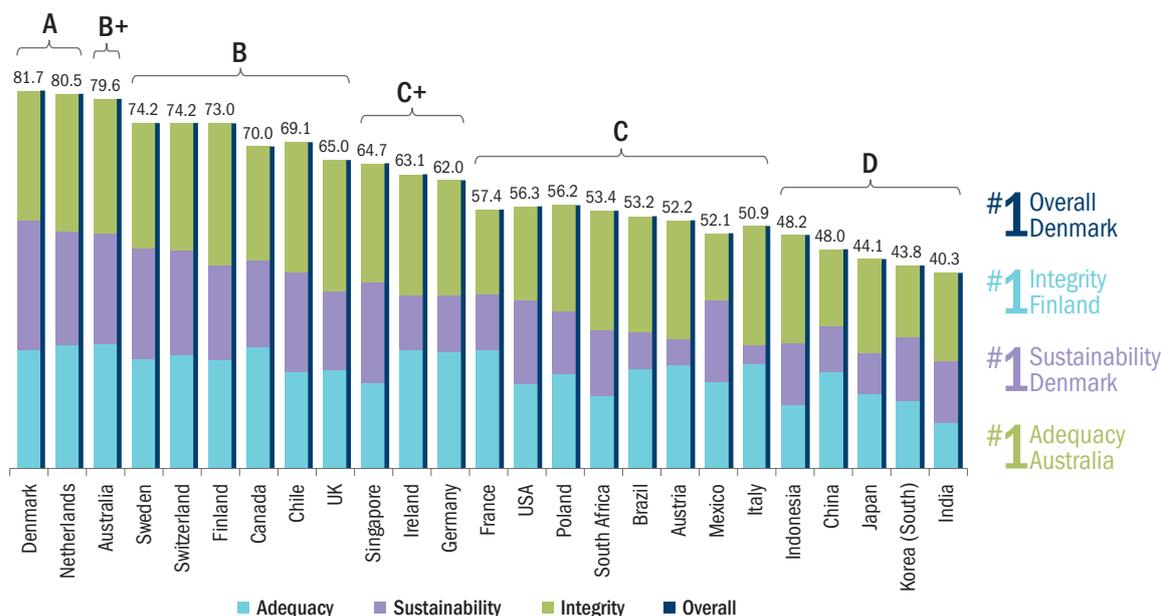
The second pillar of success is sustainability. Factors measured by the index include coverage of the system, total assets, contributions, demography and government debt.

Integrity is the third pillar. With confidence in financial systems undermined by the financial crisis and its aftermath, it is certainly an important consideration. Regulation, governance, investor protection, communication and costs underpin this last pillar.

In rating 25 diverse pension systems around the world against the 40+ indicators that comprise the MMGPI, a 40% weighting is given to those indicators that measure adequacy, 35% to sustainability and 25% to integrity. Pension systems are then categorised, according to their resulting scores out of a possible 100 points, from A to E.

<sup>7</sup> Mercer (2015), op. cit. p6.

Chart 1.2: Melbourne Mercer Global Pensions Index 2015 results



Source: Mercer (2015), Infographic, p1.

An A grade, which signifies a score of more than 80, is awarded to those countries with “A first class and robust retirement income system that delivers good benefits, is sustainable and has a high level of integrity.” By contrast, a lowly E grade is awarded to those with a score below 35, signifying “A poor system that may be in the early stage of development or non-existent.”<sup>8</sup>

In 2015, the MMGPI 2015 gave its much-coveted A-grade to two countries: Denmark and the Netherlands. At the other end of the scale, a number of Asian pension systems, including those of China and India, were given a modest D. Between these extremes, Australia was awarded a B+, the UK just cleared a B, and the US a C. Scores averaged 60.5, ranging from 81.7 for A-rated Denmark to 40.3 for D-rated India. 11 of the 25 pension systems evaluated were awarded a C or C+.

## The World Bank’s five pillar system

The MMGPI is derived from the World Bank’s five-pillar system devised in 2005<sup>9</sup> – itself evolving from a three pillar system formulated by the World Bank in 1994. It flexibly applies the model “to determine the pension system modalities and reform options that should be considered.” As summarised by MMGPI, the pillars are:

- Pillar 0:** A basic pension from public finances that may be universal or means-tested
- Pillar 1:** A mandated public pension plan that is publicly managed with contributions and, in some cases, financial reserves
- Pillar 2:** Mandated and fully funded occupational or personal pension plans with financial assets
- Pillar 3:** Voluntary and fully funded occupational or personal pension plans with financial assets
- Pillar 4:** A voluntary system outside the pension system with access to a range of financial and non-financial assets and support

The World Bank also acknowledges that owing to countries’ differing economic, social and cultural factors, there can never be a definitively and universally perfect pension system that applies to all countries at any one time. That said, the MMGPI suggests that in order to generate better financial outcomes at and in retirement, pension systems should aspire to incorporate the following desirable adequacy, sustainability and integrity characteristics:<sup>10</sup>

<sup>8</sup> Mercer (2015), op. cit. p7.

<sup>9</sup> Holzmann R and Hinz R (2005), Old Age Income Support in the 21st Century, The World Bank, Washington DC.

<sup>10</sup> Mercer (2015), op. cit. Infographic, p2.

### **Adequacy**

- A minimum pension based on a “reasonable percentage” of median earnings for those on a low income
- A 70+% net replacement rate for a median earner
- 50+% of pension benefits to fund an income stream in retirement

### **Sustainability**

- Private pensions coverage of 70+% of the working age population
- Pension assets in excess of 100% of GDP (with 175% of GDP seen as the aspiration) to fund future pension liabilities and help address, or at least limit, intergenerational inequality
- 65+% of those aged 55 to 64 in employment to fund a higher standard of living in retirement and reduce the time spent in retirement

### **Integrity**

- Strong regulation of private pension plans
- Clear, timely and practical member communications with projections of retirement income
- Clear funding requirements for DB and defined contribution (DC) schemes

## **A STANDOUT OFFERING**

Of course, when trying to design the ideal pensions system (such that it exists), it makes sense to seek out those stellar examples already in place. So it is to Denmark and the Netherlands that we turn.

Denmark, scoring 81.7, boasts a solid, well-funded multi-pillar pension system; most pensioners will be eligible for more than one type of pension and many will be eligible for more than two.

### **The first pillar**

The first pillar of Denmark’s pension scheme is a universal basic public pension called the ‘folkepension’. According to the OECD, the full basic pension amount is DKK 70,896 per year (£7,172/€9,252/\$10,399), which is the equivalent of 17% of average earnings.<sup>11</sup>

On top of that, there are other supplements, including the so-called ‘elderly cheque’, which brings a single pensioner’s annual income up to DKK 161,000 (£16,286/€21,009/\$23,615). Means-tested benefits are paid to the country’s poorer pensioners.

### **The second pillar**

The second pillar is a compulsory workplace pension scheme, run by Danish pension provider ATP (the parent company which is behind UK mastertrust NOW: Pensions). “ATP covers almost the entire population and comes close to absolute universality,” notes the OECD’s Pensions at a Glance 2015 report. The report observes that “Technically, the old age pension of ATP is a guaranteed deferred annuity.”<sup>12</sup>

The contribution workers make to ATP is a fixed amount which varies only according to the number of hours they worked. For a full-time worker in 2014, the contribution was DKK 3,240 (£329/€424/\$477). This constitutes one third of the overall annual contribution; the worker’s employer pays the remaining two thirds.

Between them, the state pension and savings within ATP account for two thirds of all pension payments made in Denmark. Over half of Danish pensioners rely on the state pension and ATP for the entirety of their retirement income.<sup>13</sup>

<sup>11</sup> OECD (2015), op. cit. p240.

<sup>12</sup> OECD (2015), op. cit. pp241-242.

<sup>13</sup> ‘Around ATP’: <https://www.atp.dk/en/about-atp/atp-in-brief>

According to ATP, 65-year-old Danes who retire this year who have been paying ATP contributions for their whole working lives will receive up to DKK 24,000 (£2,427/€3,131/\$3,519) each year for the rest of their lives.

Therefore, without taking any other private savings and other assets, like property, into account, a typical Dane can count on a fairly healthy income of £18,713/€24,140/\$27,134 in retirement. But most people save even more than that. On average, ATP and the state pension account for 80% of a typical pensioner's retirement income in Denmark, meaning the average pensioner also manages to build up a significant top-up of outside savings.

## The third pillar

This brings us to Denmark's third pillar of savings, occupational pension schemes; what ATP terms "labour market pension schemes". These are separate from ATP, which works almost as a quasi-state pension top-up for workers.

According to the OECD,<sup>14</sup> occupational schemes cover some 90% of the employed workforce: this coverage having risen dramatically from a derisory 35% in the mid-1980s.

Within occupational pension schemes, contribution rates range between 12% and 18%. The OECD observes that typically lower earning workers are enrolled in schemes with lower contribution rates whereas higher rates apply to higher income groups and the best educated. This means that replacement rates are in line with lifetime earnings. Scheme members assume investment risk, and benefits are accrued on a what-you-pay-is-what-you-get basis.

## DECONSTRUCTING DENMARK'S SUCCESS

So why did Denmark receive Mercer's coveted A-grade for the fourth year running? Partly because of the comprehensive and generous system described above but also because it scored straight As for sustainability and integrity, albeit with a B+ for adequacy.

Indeed, pension coverage does not stop when people leave conventional employment for any reason. In Denmark, the self-employed can contribute to ATP if they choose. The unemployed are not left out, either. While people are unemployed, unemployment insurance (or the municipality if the person is not insured) not only covers ATP contributions, but pays them at a double rate. If unemployment insurance runs out, the government contributes two thirds of the ATP payment. The government will also cover two thirds of ATP contributions while people take maternity or paternity leave.<sup>15</sup>

Simplicity is surely another hallmark of Denmark's success. Although its pensions system has a number of pillars, each is well structured, has clear rules and is easy to understand. Let's take ATP as an example. While eligibility for the UK auto enrolment system, introduced in 2012, is based on age and qualifying earnings, every Danish person who works more than nine hours a week pays into ATP.

Finally, through co-operation between the government, employers, collective bodies and, of course, the savers themselves, it is clear that saving into a pension is a social norm and universally recognised as an important collective responsibility by the people of Denmark.

All of these factors have contributed to Denmark's success. An oft-quoted measure of the sustainability of a country's pensions market and, to a degree, its ability to promote intergenerational fairness, is pension assets as a percentage of GDP. This provides a relative measure of how much has been set aside to fund future retirement benefits. Today, pension assets comprise an impressive 168.9% of GDP in Denmark, closely followed by 160.6% in the Netherlands. In the UK, they are 116.2%.<sup>16</sup> These levels vary drastically in a global context; pension

<sup>14</sup> OECD (2015), op. cit. p242.

<sup>15</sup> OECD (2015), op. cit. p243.

<sup>16</sup> Towers Watson Global Pension Assets Study 2015. p6.

assets held in Indonesia and in Austria are a mere 1.8% of GDP and 6% of GDP respectively.<sup>17</sup> Pension assets at such mediocre levels will invariably place a strain on the ability of the system to deliver intergenerational equality.

## THE NETHERLANDS

The Netherlands won its first A-grade in the 2015 Mercer Global Pension Index report, scoring 80.5, joining Denmark at the top of the pensions tree.

The Dutch managed to beat the Danes on adequacy and integrity, although Denmark still shone in Mercer's sustainability sub-index. The Netherlands' pension system<sup>18</sup> has three tiers. The first is a flat rate public pension available to all retirees, based on the length of time they have lived in the Netherlands. As Dutch pensions experts Eduard Ponds and Onno Steenbeek explain: "Financing is on a pay-as-you-go basis and benefits keep pace with the legal minimum wage. At retirement a couple will receive an income of approximately €1,400 a month, and a single person €1,000."<sup>19</sup> The full basic public pension is over 25% of average earnings.<sup>20</sup>

The second pillar is a quasi-compulsory workplace pensions system<sup>21</sup> where most workers save into industry-wide multi-employer schemes. More than 90% of Dutch workers are members of such schemes.<sup>22</sup> In addition, there are individual company pension funds and those established for specific groups of professionals. While the dominant pension fund structure remains mandatory funded DB plans, dramatic consolidation of the latter over the past decade allied to the imposition of strict funding requirements<sup>23</sup> has seen a marked shift to hybrid DB plans<sup>24</sup> and collective defined contribution (CDC) arrangements.<sup>25</sup>

The Dutch CDC arrangements are well-known and much scrutinised by policymakers and regulators in other countries. Indeed, recently in the UK, the former pensions minister, Steve Webb, when in office, was eager to find a middle ground between the generous (but unsustainable) DB and the affordable (but, at present contribution rates, inadequate) DC. CDC was one of the solutions he posited as part of his attempt to generate an industry-wide debate about "defined ambition". Sadly, Webb ran out of time on defined ambition and it was shelved by his successor.

In the Netherlands, CDC is offered through multi-employer, industry-wide, occupational pension schemes.

What makes CDC schemes unique is the sense of fairness that pervades the system. Every member contributes the same amount of money. Investment risk is borne collectively. However, this latter point can lead to problems when a fund gets into financial difficulties, as some did during the financial crisis. Some retirees' pensions were cut to help schemes' funding to recover. Although the cuts were minimal, this prompted a lot of negative media attention and some protests. For more on the challenges the Dutch system has faced in the wake of the financial crisis, see chapter 3. The third pillar comprises a system of voluntary savings.

<sup>17</sup> Mercer (2015), op. cit. p20.

<sup>18</sup> For an overview of the Dutch pension system, please see: *The Dutch Pension System: an overview of the key aspects*, Dutch Association of Industry-wide Pension Funds (VB), Dutch Association of Company Pension Funds. [https://www.google.co.uk/url?sa=t&rct=j&q=&resrc=s&source=web&cd=1&ved=0ahUKEwityOXditfLAhUKcRQKH5ZUDXQFgggMAA&url=http%3A%2F%2Fwww.pensioenfederatie.nl%2Fdocument%2Fpublicaties%2Fenglish%2520publications%2FNederlandse\\_pensioensysteem\\_Engelstalige\\_versie.pdf&usq=AF0jCNHBKZ66dPhSjlc9gP5PTTdtXNOXw&sig2=JPAtNeKf09pdu2h-7ayuiw&cad=rja](https://www.google.co.uk/url?sa=t&rct=j&q=&resrc=s&source=web&cd=1&ved=0ahUKEwityOXditfLAhUKcRQKH5ZUDXQFgggMAA&url=http%3A%2F%2Fwww.pensioenfederatie.nl%2Fdocument%2Fpublicaties%2Fenglish%2520publications%2FNederlandse_pensioensysteem_Engelstalige_versie.pdf&usq=AF0jCNHBKZ66dPhSjlc9gP5PTTdtXNOXw&sig2=JPAtNeKf09pdu2h-7ayuiw&cad=rja)

<sup>19</sup> *Towards a New Pensions Settlement: The International Experience*, ed. Gregg McClymont and Andy Tarrant, 2016.

<sup>20</sup> OECD (2015), op. cit. p50.

<sup>21</sup> There is no statutory obligation for employers to offer a pension scheme to employees.

<sup>22</sup> *The Dutch Pension System: an overview of the key aspects*, op. cit. p11.

<sup>23</sup> The minimum funding ratio applied to DB schemes is 105%. Moreover, as distinct legal entities, pension funds are protected if a sponsoring company experiences financial difficulties.

<sup>24</sup> Hybrid DB plans provide employee and retiree indexation conditional on the fund's financial position.

<sup>25</sup> See: McClymont and Tarrant (2016), op. cit. pp.43-51.

## CASE STUDY 1. THE UK: LEARNING FROM THE TOP OF THE CLASS

***“If Britain persists in going against the international tide and pursuing individualism in the form of pension freedom and choice, then it must build the information architecture which is necessary for people to make good, informed decisions.”***

Engineering social shifts is a difficult task, but the UK is making a good go of it with auto enrolment. It is a shame, however, that auto enrolment’s structure is so individualistic. Members bear their own investment risk, make their own contributions and now, given the implementation of pension freedom and choice in April 2015, their own decisions at retirement.

The UK is a fairly individualistic society, whereas Denmark and the Netherlands are renowned for their belief in the collective social good. It is likely that the UK’s approach will lead to extremely disparate retirement outcomes, from excellent to extremely poor.

UK DC savers are given so many opportunities to make potentially harmful choices, from opting out of auto enrolment to taking their money as a cash lump sum (and potentially suffering a huge tax hit) at the point of retirement. Moreover, letting people access their money from the age of 55 could change social norms around retirement, encouraging them to believe that accessing pensions at such an early age will not be detrimental – when the reality is quite the opposite and other countries are moving in opposite directions.

Danish and Dutch savers are given none of these choices. Instead, both countries’ employers, regulators, government and savers recognise that contributing to a robust pension scheme is in everyone’s best interests. Both Denmark and the Netherlands offer simple, robust pension systems with stringent funding requirements in which, as a consequence, outcomes are much more assured. Indeed, as previously noted, pensions are a key national asset in both countries: pension assets comprise 160.6% of GDP in the Netherlands and 168.9% of GDP in Denmark.<sup>26</sup>

The MMGPI recognised this in its latest report. While both Denmark and the Netherlands’ pension systems received A grades, freedom and choice earned the UK’s pensions system a downgrade from a firm B+ to just scraping a B.

The report states that Britain, with the world’s second largest pensions market by assets, could improve its score by “restoring the requirement to take part of retirement savings as an income stream”.<sup>27</sup>

In Australia, pensions experts were surprised when Britain decided to break with annuities. They have long sought a simpler retirement product with a greater degree of certainty around retirement outcomes than income drawdown, which is the norm in Australia – and believe that annuities could be the answer. However, people in the UK generally don’t like being told what to do with their own money and distrust excessive state interference.

Australia’s 2014 Financial System Inquiry, chaired by David Murray, estimated that retirees drawing their income via a comprehensive income product (CIPR – the equivalent to a UK annuity) would benefit from an uplift of 15-30%.

The review concluded: “Retirees using CIPRs would obtain significantly higher and smoother private retirement incomes while reducing the risk of outliving their savings.”<sup>28</sup>

<sup>26</sup> Mercer (2015), op. cit. p20.

<sup>27</sup> Mercer (2015), op. cit. p40.

<sup>28</sup> *The retirement phase of superannuation*. Financial System Inquiry Final Report. November 2014. Commonwealth of Australia 2014. ISBN 978-1-925220-14-8. p130.

## Table 1.1: Financial System Inquiry – improved incomes from example CIPRs

For a 65-year old male with a \$400,000 accumulated balance (excludes Age Pension)

	Expected income throughout retirement (NPV)	Increase over account-based pension	Increase over account-based pension (%)
Account-based pension drawn down at minimum rates	\$275,000	-	-
CIPR 1	\$314,000	\$40,000	14
CIPR 2	\$357,000	\$82,000	30
CIPR3	\$359,000	\$85,000	31

Source: Financial System Inquiry Final Report, Table 6, p130

If Britain persists in going against the international tide and pursuing individualism in the form of pension freedom and choice, then it must build the information architecture which is necessary for people to make good, informed decisions.

When the UK's Chancellor of the Exchequer [Finance Minister] George Osborne announced, in March 2014, that UK savers will no longer need to buy an annuity at the point of retirement, he promised savers would be given access to "advice" at the point of retirement. "Advice" was swiftly downgraded to "guidance", and the government has since proved reluctant to release figures on take-up of its free-to-access guidance service, Pension Wise.<sup>29</sup>

The Work and Pensions committee subsequently criticised the "shortage of information" available on how savers are responding to freedom and choice. In response to more data being made available, Frank Field MP, chair of the committee, more recently welcomed this response – "which indicated that government listens". He qualified this with: "There is, however, a lot more to come out of the various reviews and research underway, and we will continue to monitor pension freedom closely throughout this Parliament."<sup>30</sup>

There are opportunities for Britain to step back into line with countries like Denmark and the Netherlands. For instance, multi-employer occupational schemes ("master trusts") are on the rise. Of the sponsoring companies which had implemented auto enrolment as of August 2015, 51% had put their staff into master trusts.

With savers' money pouring into multi-employer schemes, opportunities to achieve economies of scale abound. Perhaps as they grow and develop, such multi-employer schemes could consider offering in-house retirement solutions, from annuities to income drawdown. In addition, such schemes could consider sharing investment risk between members – perhaps across industries or even companies.

As David Blake of the Pensions Institute observed in his recent report, *We Need a National Narrative: Building a Consensus around Retirement Income*: "It is also important to be aware of the risks involved in the generation of retirement income from pension savings [such as investment risk, inflation risk and longevity risk]. Following 'freedom and choice', these risks are now borne directly by DC scheme members... Unfortunately, many people do not understand [these] risks... Even with improved financial education, it is unlikely that many people will fully understand a number of these risks. This is because some risks have to be experienced before they can be genuinely understood, and often it is too late by that stage to do anything about them.

<sup>29</sup> Figures suggest that only one in 10 people who have taken pensions benefits post-freedom and choice have used Pension Wise, though have expressed a high degree of satisfaction.

<sup>30</sup> Frank Field MP, Work and Pensions Committee, 21 December 2015.

“... If a large group of people cannot understand the risks they face in their pension scheme, despite being provided with information about those risks, then they should not be expected to manage these risks themselves. Instead, if people can have confidence that those designing and regulating pension schemes have dealt with these risks in the most efficient and cost-effective ways possible, then it might be possible to nudge (or even default) savers into making the right choice at retirement for them and their family. To do this, we will need to build on the lessons of auto enrolment and, in particular, the issue of having a well-designed default decumulation process at retirement.”<sup>31</sup>

## CASE STUDY 2: LATAM: CHILE SETS A BENCHMARK FOR LATIN AMERICA<sup>32</sup>

The main principle of the pension fund system in Chile is simple: workers should save for their own retirement as the state can't finance pensions from national budgets alone. The state, instead, should implement and supervise a fair system that obliges workers to save for their retirement.

Chile was the first Latin American country to implement a defined contribution (DC) system in 1981. Peru, Colombia, Mexico and countries in other parts of the world have since followed the Chilean model. In this case study we summarise the three pillars of the Chilean system, one key benefit and a current challenge.

Given that the region's first pension systems were taxpayer-funded pay-as-you-go systems, the principal benefit of implementing a three pillar system is the relief it provides to central government budgets which often struggle to fully cover the nation's pension liabilities. Moreover, certain governments in the region had used pension assets to fund their own projects or as a central government overdraft facility. These two reasons in particular made the Chilean system popular; a system based on the concept of: workers should save for their own future independently of government budgets or tax revenues.

### A brief description of the Chilean system: the three pillars

The first pillar is based on obligatory contributions. Managed by private companies called Administradoras de Fondos de Pensiones (AFP), every employed person must contribute 10% of salary to the system. These amounts are saved in a separate account for each contributor, with the AFP investing these contributions in a multi-fund structure on behalf of each employee. Contributors can choose between five different investment funds, with each fund having a different risk profile, to accommodate low to high risk appetites. The investment policy of each fund is dictated by the Pension Fund Regulator, with AFPs having to invest in strict adherence of these policy parameters.

The system's second pillar is voluntary savings. These comprise saving plans designed to help contributors that would like to achieve a higher pension. Therefore, these savings act as a supplement to the obligatory pension scheme. Tax incentives are the main motivation for contributors to join this supplementary and voluntary scheme. These savings are also managed by private entities.

<sup>31</sup>The Report of the Independent Review of Retirement Income. *We Need a National Narrative: Building a Consensus around Retirement Income*. David Blake. March 2016. ISBN: 978-0-9935615-1-1 [v1/230216]. pp.32,33,35 and 40.

<sup>32</sup>Written by William Lopez, Director, LATAM, Columbia Threadneedle.

The third pillar seeks to prevent poverty within Chilean society. This is a solidarity pillar that seeks to protect: a) contributors that didn't have enough or any money saved in their accounts to obtain a pension; b) pension protection for the disabled; and c) state subsidies to young contributors that earn less than 1.5 times the minimum wage. This solidarity pillar was introduced during a pension reform in 2008. This elevates the Chilean pension system to a more social and protectionist model by subsidising the less affluent within its population.

The Chilean pension model provides two main options for retirement that could be also combined subject to the contributor's needs. The retirement age is 65 years for men and 60 years for women:

- a) Retirement Plan: the contributor keeps the pension savings account. The savings are divided into annual sums by an actuarial calculation that takes inflation and longevity into account.
- b) Annuities: the contributor enters into a contract with an insurance company which agrees to pay a fixed monthly payment to the contributor for the rest of their life.

### An Advantage: Multi-fund structure

The Chilean system created a multi-fund structure which has been replicated within other DC systems. The main objective of a multi-fund structure is to increase the expected value of the contributors' savings according to their investment time horizon and risk appetite.

It is important to clarify that the pension system doesn't allow contributors to invest their own money directly. Instead, as noted earlier, contributors have the option to choose between five different funds (A, B, C, D, E). A is the riskiest portfolio and E the most conservative, with each having a strict investment regime as illustrated in the following table. This shows the percentage equity limits and minimums applied per fund.

Multi - Fund	Maximum Limit Equities	Minimum Limit Equities
Fondo A	80%	40%
Fondo B	60%	25%
Fondo C	40%	15%
Fondo D	20%	5%
Fondo E	5%	0%

Limits are placed on the extent to which contributors can move from one fund to the other. These principally relate to the age of the contributor. For instance, it would not make any sense for a 55-year-old contributor to be in Fund A, if close to retirement. In contrast, it wouldn't make any investment sense for a 25-year-old to be in portfolio E. There are certain restrictions that prevent contributors transferring from one fund to the other. However, there is also an automatic allocation subject to age. The automatic classification is shown in the following table:

Multi - Fund	Men and Women ≤ 35	Men 36 - 55 Women 36 - 50	Men ≥ 56 Women ≥ 51
Fondo A			
Fondo B			
Fondo C			
Fondo D			
Fondo E			

## A Disadvantage: Peer group benchmarking

So how is pension fund performance measured? Well, Chile, Peru and Colombia apply a peer group approach whereby there is a minimum return that pension funds need to generate. The minimum return is calculated as a weighted average of the returns from all portfolios over 36 months. We will not discuss in detail the calculations that result in the minimum return measure nor the details of the measures. However, it is crucial to highlight that if an AFP underperforms the minimum return benchmark, they need to cover the performance shortfall from their own balance sheet. If there is no capacity to do so, the AFP is liquidated and the government must make good the shortfall.

The impact of these measures generates distortion in the management of portfolios in that the biggest pension funds lead the investment allocation and the smallest follow. In so doing, smaller AFPs avoid being behind the benchmark. This creates an unusual basis by which to measure the relative performance of portfolios. For example, the international equity portfolio should or could be measured against an international world equity portfolio benchmark such as the MSCI AWCI. This doesn't happen in practice as the benchmark becomes the international equity portfolio of the bigger AFPs. Ultimately, this herding creates a big distortion in the asset allocation adopted by the AFPs and arguably results in sub optimal portfolios.

## Conclusion

In conclusion, the Chilean Pension System is a model adopted in many countries around the world. The three pillars on which the system is based are both well-structured and equitable. Moreover, the system differentiates the risk profiles of its contributors to maximise investment returns for those with a long investment horizon and minimise risks for those who are close to retirement. However, the peer group benchmarking of these funds remains an issue.

## CHAPTER 2: THE INGREDIENTS OF A GOOD PENSION

### KEY POINTS

- Starting pension saving early can make a huge difference to retirement outcomes.
- While the pension systems with the highest replacement rates in the world tend to have some element of compulsion, well established voluntary private pension systems have a materially positive effect on outcomes.
- With declining fiscal fortunes, governments are turning to private pension savings and relying on individuals to take greater responsibility for their own financial futures.
- An effective pension system must be attuned to changes in life expectancy and prepared to adjust retirement ages accordingly.

### INTRODUCTION

In chapter 1, we examined examples of great pensions systems around the globe. In this chapter, we will take a deeper look at the ingredients which, when combined, create good pensions outcomes for savers.

### WHEN TO START SAVING

When it comes to saving for a pension, it's clear that starting early can make a huge difference to retirement outcomes. The Pensions Policy Institute (PPI) found, in *The Future Book*, that starting to save in the UK at age 30 instead of age 40 could produce a private pension income which is nearly 50% higher: £59,500/€76,755/\$86,275 instead of £40,600/€52,374/\$58,870.<sup>33</sup>

The PPI found that savers who lose ten years of saving might need to contribute an extra 4% of their earnings into their pension for the rest of their working lives. Additional PPI modelling found that in order for there to be a two thirds probability of replicating working life living standards in retirement, a median earner would need to contribute 11% to 14% of band earnings<sup>34</sup> from age 22 to state pension age without any career breaks and assuming that the UK state pension retains its unique annual “triple lock” index linking (the higher of 2.5%, nominal wage growth or the consumer price index). For those who start contributing later and/or take career breaks, this contribution rate could escalate to 27%.<sup>35</sup>

In the UK, the age when workers become eligible for auto enrolment is 22, so long as they are earning over £192/€248/\$278 per week. Elsewhere in the world, people start saving into workplace pension schemes much earlier.

In Denmark, employees start saving into ATP at the tender age of 16.<sup>36</sup> In Australia, generally savers become eligible for superannuation as soon as they are being paid more than \$450 Australian dollars (£225/€290/\$326) before tax in a calendar month and working for 30 hours a week or more.<sup>37</sup>

From a policy perspective, it is tempting to ease UK employers into setting up workplace pension schemes under auto enrolment by not insisting that they enrol savers as soon as they start work. However, starting later than countries with more sustainable pension systems will clearly reduce UK savers' eventual outcomes.

This may be unavoidable. Societal change in the UK means that young people are joining the workforce later. Despite a dip in university applications in 2012 following the introduction of tuition fees, the proportion of 18-year-olds accepted for full-time undergraduate study reached its highest ever level in the UK in 2013.<sup>38</sup>

<sup>33</sup> *Closing the gap: the choices and factors that can affect private pension income in retirement*, Pensions Policy Institute, 2012.

<sup>34</sup> Band earnings are between £5,824 to £43,000 in 2016/17.

<sup>35</sup> *The Future Book: unravelling workplace pensions*. Daniela Silcock, Tim Pike and Shamil Popat. Published by the Pensions Policy Institute, October 2015. ISBN:978-1-906284-34-3. See p24.

<sup>36</sup> Pension Funds Online: <http://www.pensionfundsonline.co.uk/content/country-profiles/denmark/119>

<sup>37</sup> Australian Tax Office: <https://www.ato.gov.au/General/Other-languages/In-detail/Information-in-other-languages/Your-superannuation-basics/>

<sup>38</sup> *Patterns and Trends in UK higher education 2015*, Universities UK: [http://issuu.com/universitiesuk/docs/patternsandtrends2015\\_23aa97d68a4d62/5?e=15132110/31968656](http://issuu.com/universitiesuk/docs/patternsandtrends2015_23aa97d68a4d62/5?e=15132110/31968656)

That said, Denmark still boasts a significantly higher proportion of 20-29 year olds in higher education than the UK. According to the OECD’s most recent report on education trends, only 21% of UK 20-29 year olds were enrolled in education in 2013, compared to 45% of Danish twentysomethings and 31% of Dutch young people.<sup>39</sup>

It’s difficult to prescribe a particular age at which people should start saving. The answer could lie in the Australian system. It is well-known that UK graduates earn more than non-graduates over their lifetime.<sup>40</sup> So why not set up the system whereby those who choose to start working straight out of school start saving at the same time, with graduates starting to save when they enter the workplace?

For more about the changing societal dynamics that can disrupt saving, please turn to chapter 3.

## THE IDEAL REPLACEMENT RATE

***“It’s clear that well-established voluntary private pension systems have a material effect on outcomes.”***

When considering how much to save in order to achieve the ideal replacement rate, it is logical to start by examining the countries with the best replacement rates.<sup>41</sup> How did they get there?

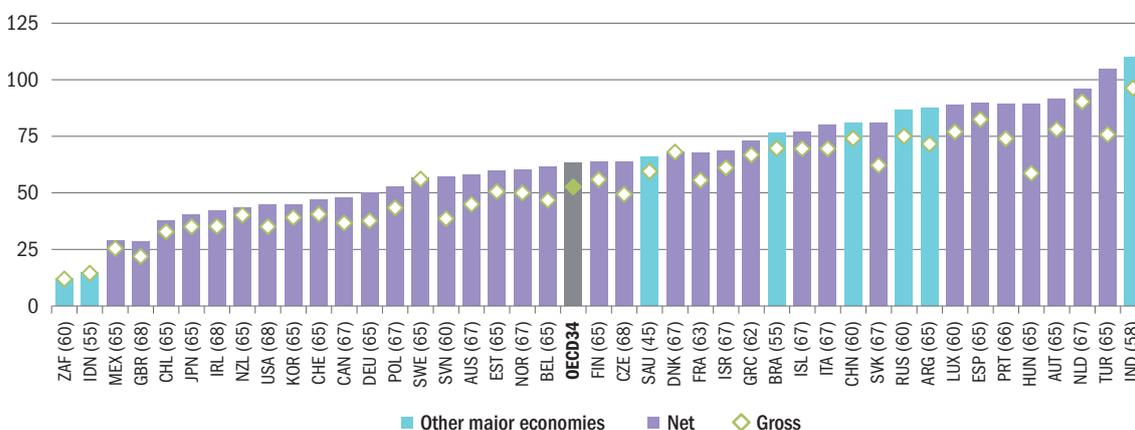
According to the OECD, the countries with the highest replacement rates for low-income earners are Denmark, Luxembourg, the Netherlands and Turkey. “Low income earners generally have higher net replacement rates than average-income earners due to the progressivity of the tax-pension benefit systems that is in place in most OECD countries”.<sup>42</sup>

It’s clear that well-established voluntary private pension systems have a material effect on outcomes. The OECD average for net replacement rates for a median earner from public and mandatory private schemes alone is 63%. When voluntary private pensions are added, the replacement rate goes up to 68%. When voluntary private pension systems are widespread, as is the case in seven OECD countries, the replacement rate increases to 71%.<sup>43</sup>

The OECD examines net pension replacement rates from mandatory public, mandatory private and voluntary private pension schemes as a percentage of earnings. As can be seen from charts 2.1 and 2.2 below, the net replacement rate for low earners in the UK is over 90% of the OECD average, whereas for high and median earners it is 46% and 60% of the OECD average respectively. This clearly indicates there is some way to go before UK savers overall can claim to have achieved good outcomes from the system.

For average earners, the countries offering the best net pension replacement rates are India, Turkey, the Netherlands, Australia and Brazil.

**Chart 2.1: Net pension replacement rates: median earners**



<sup>39</sup> OECD Education at a Glance, 2015, p316 [http://www.keepeek.com/Digital-Asset-Management/oced/education/education-at-a-glance-2015\\_eag-2015-en#page318](http://www.keepeek.com/Digital-Asset-Management/oced/education/education-at-a-glance-2015_eag-2015-en#page318)

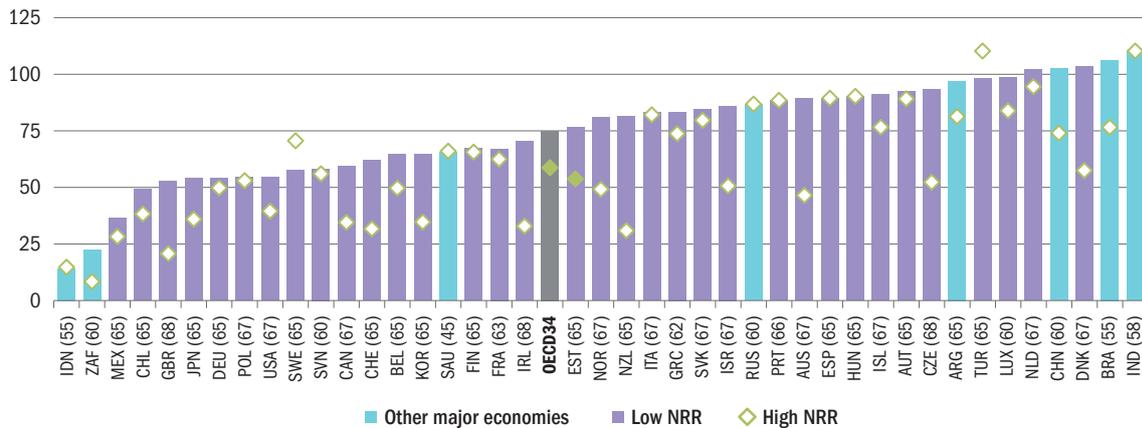
<sup>40</sup> According to data from the Department for Business, Innovation and Skills.

<sup>41</sup> A replacement rate, which can be expressed in gross or net terms, is the percentage of pre-retirement income received in retirement. Other things equal, the replacement rate should be higher for low earners than high earners, though for comparative purposes it is often expressed for a median earner.

<sup>42</sup> OECD (2015), op. cit. p27.

<sup>43</sup> OECD (2015), op. cit. p146.

Chart 2.2: Net pension replacement rates: low earners and high earners



Source: OECD (2015). Charts 6.8 and 6.9, p145. Low and high earners represent 0.5 and 1.5 times the income of the median earner.

The Dutch and Danish systems have already been discussed in chapter 1, so let's turn to some less commonly discussed pensions systems which boast enviable replacement rates.

Turkey has a very generous quasi-public/private pensions system, which goes a considerable way towards explaining its high replacement rates. Employees and employers must both contribute to the government-administered pension system, at rates of 9% and 11% respectively.<sup>44</sup> The Turkish system also supports retirees with a means-tested pensions benefit.

New regulation has given Turkey's private pensions system a boost. The government has been making limited contributions to private pensions in order to boost overall savings, Reuters reported in 2013.<sup>45</sup> The news agency said that 120,000 people joined private pension schemes in January 2013 alone, to capitalise on the new incentives.

The Turkish government also increased its incentives for employers to contribute to employee pensions. Contributions of up to 15% of employees' gross wages can now be offset against employers' business income. The government has also increased tax efficiencies within the pensions system. As a result, a system which gained three million new savers within a nine-year period from the end of 2003 to the beginning of 2013 then saw a rapid increase to five million new savers in 2014.<sup>46</sup>

The reforms to the Turkish pensions system were introduced in response to a perceived reticence in Turkey's population to save, following the hyperinflation of the mid-1990s which rendered many savers' accounts worthless.

Similar to Turkey, Brazil's pensions system is mandatory for workers, with employers and employees contributing to a national scheme which is run by the National Social Security Institute. Savers can retire at any age after 35 years' contributions to the system for men and 30 years for women. Contributions work on a tiered basis; those earning upwards of BRL 1,317.07 (£232/€299/\$336) monthly must save 8%, the rate is 9% for those earning BRL 1,317.07-2,195.12 (£232-388/€299-500/\$336-563) and 11% for those earning BRL 2,195.13-4,390.24 (£388-775/€500-1,000/\$563-1,124). These rates especially benefit those earning low incomes, according to the OECD.<sup>47</sup>

Looking at the Brazilian and Turkish examples, the decisive factor that both systems have in common is their high contribution rates. In chapter 1, we saw a similar story in Denmark and the Netherlands.

<sup>44</sup> Mondaq, Turkey: Pension Funds: The Road to a Pleasant Retirement <http://www.mondaq.com/turkey/x/356840/retirement+superannuation+plans+pensions+schemes/Pension+Funds>

<sup>45</sup> Pension reform set to unlock Turkey's fund management industry, Reuters, 6 March 2013 <http://uk.reuters.com/article/turkey-pensions-idUKL6N0BWA1B20130306>

<sup>46</sup> Individual Pension System 2014 Progress Report, Pension Monitoring Centre, 4 May 2015.

<sup>47</sup> OECD (2015). op. cit. pp.222-223.

## WHAT CAN THE UK TAKE FROM THIS?

Clearly, there is a need to balance employers' profitability and sustainability with the need to increase savings in the UK private pensions system. Mercer's Global Pension Index gives Brazil's system a far lower sustainability score (24.5) than the UK's (51.3). (Turkey isn't included within the MMGPI). Every country will have its own intricate balance of state, workplace and private pension savings, along with different rules on means-testing.

However, numerous studies have shown that at present, the UK's contribution rates are insufficient to give enough people a good chance of a comfortable retirement. As noted earlier, the Pensions Policy Institute estimated a savings rate of 11% to 14% from age 22 to state pension age, assuming the state pension retains its generous index-linking, will be sufficient to give people a decent chance of a comfortable retirement, in its report *The Future Book*.<sup>48</sup> At the moment, the UK is a long way away from achieving that rate in DC pensions – increasingly the pension savings vehicles of today and most certainly tomorrow. Therefore, it's critical to consider ways to get UK savers putting more money aside for their pensions.

## THE MERITS OF COMPULSORY SAVING

From Australia to Brazil, the pensions systems with the highest replacement rates in the world tend to have some element of compulsion.

Australia first made superannuation compulsory in 1992. Since then, superannuation assets have grown fast, as has Australia's replacement rate. Assets have grown from AUS \$635bn (£338bn/€436bn/\$490bn) in 2004 to AUS \$1.85tn (£990bn/€1.28tn/\$1.44bn) in 2014.<sup>49</sup>

The decision to take a country down a compulsory as opposed to a voluntary route often depends on the ideology of the prevailing political party. Socialist policies typically favour redistribution in retirement in the form of paternalistic, mandatory pension saving, which typically results in a narrower range of outcomes for retirees.

For instance, a Labour government introduced paternalistic superannuation in Australia. Denmark, with its multi-party political system, is known for its paternalism – and like Australia, has a compulsory pensions system.

However, compulsory saving comes with some trade-offs. Such systems can prove unpopular with employers, since it requires them to spend more money on pensions, as opposed to growing their business or giving staff pay rises. If the government sweetens mandatory saving in some way – via tax breaks, for instance – then that can also lead to an increase in public spending.

That's why in using the "reverse default nudge" of auto enrolment to overcome the inertia associated with getting people to save into a pension, by requiring them to make the effort to opt out, rather than opt in, has been applied with great success not only in the UK but also in the US, Chile, New Zealand, and more recently in Canada and soon Ireland. For this very reason, auto enrolment continues to attract worldwide attention.

<sup>48</sup> *The Future Book*. op. cit. p24.

<sup>49</sup> *Supertrends: Australian superannuation industry* <https://www.kpmg.com/AU/en/IssuesAndInsights/ArticlesPublications/Documents/supertrends-australian-superannuation-industry.pdf>

Table 2.1: Coverage of private pension schemes by type of plan, 2013, as a percentage of working-age population (15-64 years)

	Mandatory/quasi-mandatory	Voluntary		
		Occupational	Personal	Total
Australia	68.5	x	19.9	19.9
Austria	x	15.1	18.0	-
Belgium	x	57.3	-	-
Canada	x	25.7	24.7	-
Chile	78.9	-	-	-
Czech Republic	x	x	66.2	66.2
Denmark	ATP: 88.3 QMO: 62.3	x	22.4	22.4
Estonia	74.3	x	5.1	5.1
Finland	84.1	9.2	20.9	29.1
France	x	20.2	5.3	-
Germany	x	56.4	35.2	71.3
Greece	x	0.2	-	-
Hungary	x	-	18.5	-
Iceland	87.9	x	52.2	52.2
Ireland	x	31.0	12.0	41.3
Israel	94.2	x	x	x
Italy	x	7.4	8.9	15.7
Japan	-	-	-	-
Korea	13.9	x	23.4	23.4
Luxembourg	x	5.2	-	-
Mexico	57.8	1.7	x	1.7
Netherlands	88.0	x	28.3	28.3
New Zealand	x	7.2	72.9	-
Norway	68.6	-	22.3	-
Poland	60.3	1.4	-	-
Portugal	x	3.2	4.0	-
Slovak Republic	55.3	x	-	-
Slovenia	x	-	-	36.3
Spain	x	3.3	15.7	18.6
Sweden	PPS: ~100 QMO: ~90	x	36.0	36.0
Switzerland	72.6	x	-	-
Turkey	1.4	0.5	6.9	-
United Kingdom	x	30.0	11.1	43.3
United States	x	41.6	22.0	47.1

Note: QMO = Quasi-mandatory occupational; PPS = Premium Pension System; - = Not available; x = Not applicable. Coverage rates are provided with respect to the total working-age population (i.e. individual aged 15 to 64 years old) for all countries except Germany, Ireland and Sweden for which coverage rates are provided with respect to employees subject to social insurance contributions for Germany and to total employment for Ireland and Sweden.

Source: OECD (2015). Table 10.1. p187

## 2005: SHOULD THE UK ADOPT COMPULSION?

When the government-appointed Pensions Commission wrote its seminal report on the state of UK pension provision in 2005, one key question was whether it would recommend a mandatory private pensions system.

The commission reached an open-ended conclusion. However, reasons not to introduce a mandatory system were discussed. These were underlined by the commission's feeling that people want to be free to make their own financial choices.

The report said: "While many people say they want to "have to save", many respond adversely to the idea of compulsory savings. And there is a danger that compulsory savings contributions may be seen as equivalent to taxation, reducing people's willingness to support an adequate system of flat-rate state pension provision."<sup>50</sup>

The commission also made the point that blanket pension saving is not for everyone. The commission said: "For while compulsory earnings-related provision would in many cases serve people's underlying self-interest, in some cases it would not. Individual preferences as between saving and working longer vary... some people will achieve adequate resources to support consumption in retirement through home ownership, while others will not. Compulsory pension saving therefore creates the risk that some people are forced to over save. This may also provide a strong argument for preferring auto enrolment to compulsion."<sup>51</sup>

As noted above, the UK is not the only country embarking on a middle ground savings vehicle which is aimed at encouraging workers to save. Ireland is introducing an occupational pension scheme called MyPension, while Canada has introduced a system called the Pooled Registered Pension Plan in some states.

Pablo Antolin, principal economist at the OECD, pointed out in an interview with the authors of this paper: "When policymakers tell us that the main objective is to have as wide a coverage as possible, we say the systems with the widest range of coverage are compulsory. So if that is your policy objective, we suggest a compulsory system.

"Nudge systems [like auto enrolment] are quite good in increasing coverage and we have a chapter in Pensions at a Glance 2015 saying [nudge] has managed to increase coverage enormously, but of course it is second best if your policy objective is to have as high a coverage as possible."<sup>52</sup>

## GOING PRIVATE

***"All over the world, people will be forced to start taking more responsibility for their pensions savings."***

All over the world, governments are realising that they cannot afford to offer the generous state pensions of yesteryear, owing to increasing life expectancy and declining fiscal fortunes. They are turning to private pension savings and relying on individuals to take greater responsibility for their own financial futures, rather than paternalistic government intervention, to fill the gap.

<sup>50</sup> A New Pension Settlement for the Twenty-First Century: The Second Report of the Pensions Commission, 2005, p3.

<sup>51</sup> A New Pension Settlement for the Twenty-First Century, op. cit., p86.

<sup>52</sup> For more about the theory and context behind nudge and other behavioural techniques used to improve individual retirement outcomes, please see chapters 3 and 4.

“I think it is important that each country establishes the long-term objectives of the system,” says David Knox, senior partner at Melbourne Mercer and lead author of the Global Pension Index report, in an interview with the authors of this report. “If you have a state pension what is the purpose of that? What is the purpose of a mandatory system? A voluntary system? Whilst also recognising that people will have sources of income in retirement that are outside the system.”

Knox emphasises that no one solution will fit every country, as political, social and economic dynamics vary so broadly. However, he believes that all over the world, people will be forced to start taking more responsibility for their pensions savings.

“Particularly post global financial crisis, governments are in debt and aware of the cost of the promises of social security. We have ageing populations around the world. Governments are saying that somehow or another we have to cut back on public spending and the promises the government once made to you.

“Once you start doing that you have to go back to the objectives. That means the private sector has to pick up the gap. Occupational pension systems start to become more important.”

“Self-sufficiency is a global trend,” agrees Pablo Antolin, principal economist at the OECD.

## THE UNITED STATES

The United States has a long-established DC system which relies heavily on individual contributions and engagement at the point of retirement.

How does it fare in Melbourne Mercer’s Global Pensions Index? Despite its relatively long history of DC provision, the US only achieved a middling rank C. Scoring 56.3, it lagged the average score of 60.5.

To improve its score, Mercer recommends that the US should adjust levels of mandatory pension contributions to increase the net replacement rate for median income earners, and reduce pre-retirement leakage by further limiting the access to funds before retirement.

These recommendations suggest that more government intervention, rather than less, would improve financial outcomes in the US.

Moreover, when saving is voluntary, it can mean that large swathes of the workforce simply don’t save. This is the case in the US, where only around half of the US workforce is covered by DC, according to a report by TOR Financial for the DC Investment Forum.<sup>53</sup>

More encouragingly, where savers have chosen to save into a DC plan, they engage. “Self-managed investment solutions are more the norm due to the level of sophistication by investors”, notes the DC Investment Forum report.

However, the number of investment choices available to savers has fallen in response to statistics which show that people are less inclined to make a choice when given many options (the paradox of choice), notes the report.

<sup>53</sup> Global Comparisons of DC Plan Investment Design. TOR Financial. DC Investment Forum. p14.

## WORKING LATE

We are living for longer. Across the OECD's 34 countries between 2010 and 2015, the average 65-year-old woman could expect to live another 20.8 years and her male counterpart for another 17.4 years. By 2060-65, these numbers are forecast to increase to 25.8 years and 21.9 years respectively.<sup>54</sup>

That's why life expectancy is a central consideration in any effective pension system. A key challenge is that increases in life expectancy are not linear, and some countries are experiencing faster increases in life expectancy than others. Equally, this is also translating into longer periods spent in retirement, again with some countries experiencing greater increases than others. For instance, Chile has experienced an increase of more than four years between 2009 and 2015 whereas the US has experienced an increase of 0.4 years, according to Mercer's Global Pensions Index.<sup>55</sup>

Therefore, it is difficult to prescribe a universal formula for excellence. What is clear, however, is that an effective pension system must be attuned to changes in life expectancy and prepared to adjust retirement ages accordingly.

It's very easy to agree on an ideal. What is more difficult is the reality of introducing such changes to a public who will in almost all cases feel negatively about the idea of working for longer.

Lots of warning will soften the blow. "Changes to retirement ages have to be made gradually. We are seeing governments recognising that," says Mercer's David Knox.

Knox recalls another potentially difficult negotiation – the Australian government's decision to introduce a mandatory pension system in 1992. "The government negotiated an agreement with the unions that people should forego salary increases to build up the pension system. That was an unusual confluence of events as to how we go there and I'm not sure how we could repeat it," he says.

The short-term financial hit of introducing mandatory pension saving was softened by a period of strong economic growth, leading to wage growth, in the 1990s, says Knox.

This example illustrates the fact that sometimes, good pensions systems happen by accident. "If you look at countries with good pension systems, it wasn't always planned," observes Knox.

That said, there are some clear learnings which could equally apply to changes to retirement ages: when making changes, lots of warning is key. Engaging with and achieving buy-in from key stakeholders such as trade unions could also smooth the process.

A case in point is the decision, taken by the UK government in 2011, to accelerate the timetable for the equalisation of the state pension age for women, born in the 1950s, from age 60 to 65 without consultation or giving any prior notice of the change. Moreover, despite an online petition organised by WASPI (Women Against State Pension Inequality) attracting 125,000 signatures, the government hasn't wavered from implementing the changes.

<sup>54</sup> OECD (2015), op. cit. p156.

<sup>55</sup> Mercer (2015), op. cit. p22.

## CHAPTER 3: MAKE OR BREAK: THE SOCIETAL FACTORS WHICH COULD STYMIE A GOOD RETIREMENT OUTCOME

### KEY POINTS

- Demographic challenges are prominent in driving significant workplace pension reform.
- Intergenerational inequality in wealth and income is marked across the OECD with relative rates of poverty having shifted from the old to the young.
- Women generally experience poorer retirement outcomes than men as do those who aren't part of the full-time employed workforce.
- Without trust, people are unlikely to engage with pensions and will actively decide to opt out of the system.

### RETIREMENT SYSTEMS UNDER STRAIN

In recent years, a series of related events have put retirement systems worldwide under unprecedented strain.

Gerard Riemen, managing director of the Federation of the Dutch Pension Funds, explains how in the aftermath of the 2008 financial crisis, society's relationship with pensions has changed in the Netherlands. "Everything that was taken for granted before 2008 is now questionable," he says.

Before the crisis, saving into a pension for one's working life and then drawing from a collective pot in retirement was widely accepted. "You could say nobody cared about this pension because everything went well, you paid your premium, you got a benefit so nobody was interested. There was no discussion about a mandatory system and no discussion about having no choice", says Riemen.

The financial crisis changed everything. "It was really a shock for a lot of people, for the participants in the pension funds, when they found out that it was possible not only that indexation could be skipped but even their accrued pension rights could be lowered. That was something beyond imagination before 2008," says Riemen.

He continues: "It started a range of questions and discussion. 'What about the quality of the board members of the pension fund? Why am I a member of a pension fund if they can cut my benefits? Why can't I invest my money on my own?'"

Moreover, low interest rates have left Dutch liabilities "sky high", says Riemen. "We have a paradox – we have doubled our assets since before the financial crisis and now have €1.7trn of assets... but our funding ratio is still below 100. That's because our liabilities went up at a much faster rate. We have a huge discussion now in the Netherlands. What's the right discount rate?"

He continues: "We are talking about cutting benefits in 2017 and people don't understand. They say, 'How can that be? We have doubled our assets since the start of the financial crisis and still you talk as if there is no money.'"

In the Netherlands, attempts are being made to reform the pensions system in order to find a middle ground between what they understand as defined benefit (DB) and what we in the UK call collective defined contribution (CDC) and the other extreme of defined contribution. "It could be some kind of hybrid scheme", says Riemen, maintaining risk sharing and collectivity, but with no accrued pension rights assumed.

“The challenge, of course, is will people understand this kind of scheme? They all grew up with the idea that a DC scheme is the worst thing you can get. Will people see the necessity?” muses Riemen.

## A COMMON CHALLENGE

Whilst it has its own idiosyncratic challenges, the Dutch example also encapsulates some pension problems that have been almost universal in beleaguered Western economies in recent years. Indeed, the financial crisis, and the ensuing new normal of sub-par economic conditions, has led not only to poor investment returns but also ballooning liabilities for DB schemes, with interest rates having fallen and remained at historically low, even negative, levels. In most cases, the widening gap between assets and liabilities has continually failed to be plugged by sponsor deficit contributions. Simultaneously, an ageing population allied to longer periods spent in retirement and state pensions being paid ever later in life, suggests an even greater reliance on scheme investment returns, further straining already-stretched resources.

All of these related challenges could lead to people failing to achieve their financial goals at and in retirement. In many cases – such as in the Dutch case where schemes have been robustly funded with contributions – this is through no fault of the public.

## Demographic changes

***“There is only one way of making longer lives more affordable: lengthening working lives and decreasing the number of years spent in retirement.”***

There are a number of factors that could potentially thwart a good outcome, either at an individual or a societal level. The OECD outlines the unsolved problems which are causing it concern. Demographic changes are high on the list. “The extent to which individuals, of all ages, will be willing and able to work more and longer will be a crucial issue in aging societies”, the report reads.<sup>56</sup>

Ageing populations are also at the top of Mercer’s list. “Significant pension reform is being considered or implemented in many countries due to their ageing populations arising from lower fertility rates and increasing life expectancies,” according to the report.<sup>57</sup>

There is only one way of making longer lives more affordable: lengthening working lives and decreasing the number of years spent in retirement. Most countries recognise this, although have had varying levels of success in implementing reform (see chapter 2).

## Labour market entry and exit

A related problem is that companies often still passively encourage workers who are made redundant to take early retirement. As it is explained in the OECD’s report: “This approach, which is internalised by employers and employees, gives older workers little opportunity to re-train and acquire new skills to strengthen their employability.

“Early retirement also exposes individuals to future poverty as income needs at a much higher age are often underestimated. Early retirement systems should be eliminated, and employment difficulties faced by the elderly should be dealt with by unemployment systems that promote activity as a way to protect and help people remain in the labour market longer.”<sup>58</sup>

Another factor which could lead to impoverished retirements is the fact that the age when people start saving is rising. The OECD found that delaying entry into the labour market by five years for an average wage worker results in an average pension loss of 6%. The largest impact is felt in Chile

<sup>56</sup> OECD (2015), op. cit. p31.

<sup>57</sup> Mercer (2015), op. cit. p3.

<sup>58</sup> OECD (2015), op. cit. p32.

and Mexico, at 15%. A slightly lower average pension loss of 4% is experienced by those taking a five year career break.<sup>59</sup>

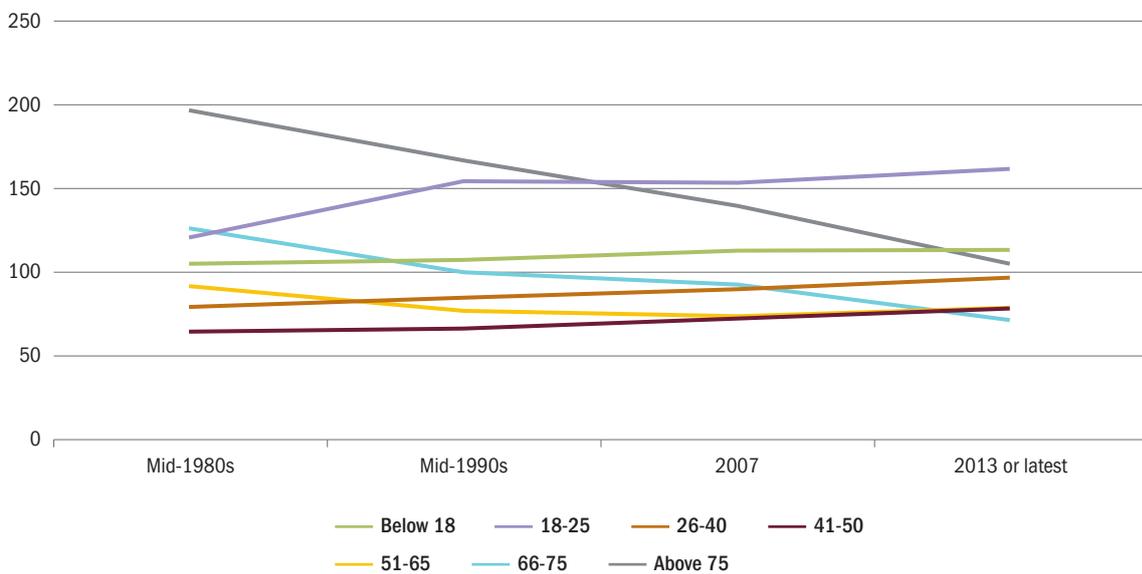
The OECD puts the average age of labour market entry at 21.9 years for men and 23.5 for women in 21 OECD countries.<sup>60</sup> It also observes that, “Most OECD countries have seen sharp rises in numbers of students and the length of time they stay in education over time – the average length of schooling increased by more than eight months on average in the OECD area between 2004 and 2012.”

One reason why people are entering the labour market later is that they are spending more time in education – which is likely to ultimately improve their career and earnings potential. A more negative reason is the financial crisis and the impact it has had on young people trying to get their first job.

### Intergenerational inequality

According to the OECD, at least 20% of 16-29 year olds are not in employment, education or training (NEETS) in Greece, Ireland, Italy and Spain – countries which have been worst hit by the financial crisis. Intergenerational inequality is already a pensions hot topic; this could further exacerbate tensions. Indeed, the OECD notes the shift in the distribution of GDP amongst the old and the young. As shown in Figure 3.1 below, since the mid-1980s, relative income poverty rates of the 66-75 age group across 18 OECD countries have fallen below those of the 18-25s, culminating in that cohort becoming the wealthiest of all the age groups. Moreover, the over-75s, traditionally the poorest age cohort across the OECD have, since the early 2000s, improved their relative position quite dramatically, leaving the 18-25 cohort the poorest by far in the OECD.

**Figure 3.1: Poverty has shifted from the old to the young across OECD countries**



Note: OECD un-weighted average for 18 OECD countries for which data are available from the mid-1980s: Canada, Denmark, Finland, France, Germany, Greece, Israel, Italy, Japan, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Sweden, Turkey, the United Kingdom and the United States.

Source: OECD (2015), Figure 1.3. p18.

<sup>59</sup> OECD (2015), op. cit. p14.

<sup>60</sup> OECD (2015), op. cit. p77.

## INTERGENERATIONAL INEQUALITY IN THE UK

In the UK, the topic of intergenerational inequality gained significant prominence in 2010 with the publication of “The Pinch: How the baby boomers took their children’s future – and why they should give it back.” Written by former UK cabinet minister, David Willetts, now Chair of the Resolution Foundation, the book showed the extent to which the vast majority of the wealth in the UK, principally comprising pensions and housing, was owned by those born between 1945 and 1965.

Given the high fertility rates of the mid-1940s to the mid-1960s,<sup>61</sup> with over 800,000 births per annum, and more than 1m births in 1947, 1964 and 1965, this is an especially large cohort of the UK population. It is also a generation that has benefitted significantly from government spending and tax cuts, defined benefit (DB) pensions schemes and the rising prices of owner occupied housing.

By contrast, the UK’s Institute for Fiscal Studies (IFS) has identified that today’s 40 year olds are earning less now than they were 10 years ago, and, like many of their younger counterparts, are indirectly paying to plug the deficits of DB pension schemes from which they will never benefit. Given the above, perhaps unsurprisingly, the IFS also found that those in their mid-20s are now half as likely as their peers were 20 years ago to be able to gain a step on the first rung of the housing ladder. This explains the significant fall in the rate of home ownership in the UK.<sup>62</sup>

Consequently, the UK has moved from a position where 30 years ago pensioners were at least three times as likely to be poor as non-pensioners, to one since 2011 where pensioner incomes have exceeded non-pensioner incomes. Indeed, pensioners’ incomes have continued to rise post-recession as the incomes of working-age households have fallen, with pensioners having largely been insulated from government post-crisis austerity measures. As a result, a large proportion of those retiring now will actually be better off in retirement than they were on average during their working life. Indeed, IFS modelling shows that pensioners’ incomes will continue to rise for at least the next decade.

Yet that generation’s parents have their own problems. The baby boomers are the “sandwich generation”: tasked with looking after ageing parents and adult children who are often dependent for longer, because of the lingering aftermath of the financial crisis.

## Women’s shorter working lives

This is a particular problem for women, who often stop working to care for their families. The OECD notes that women have shorter working lives than men in all OECD countries. Women aged 65 and over in 2008-9 worked 13 years less than men on average in the 13 OECD countries covered by a survey by Sharelife. Moreover, according to Eurostat, even now at age 18, women can expect to work three years less than men on average.<sup>63</sup>

“These disparities translate into lower old-age pensions – women’s average mandatory pension benefits being 28% lower than men’s in 2011 in 25 OECD countries [according to a 2013 study by D’Addio]”, the OECD explains.<sup>64</sup>

<sup>61</sup> See OECD (2015), op. cit. Table 7.1, p155.

<sup>62</sup> High levels of income for current retirees shouldn’t blind us to future challenges. Paul Johnson. Institute for Fiscal Studies. 20 October 2015.

<sup>63</sup> OECD (2015), op. cit. p81.

<sup>64</sup> OECD (2015), op. cit. p81.

In the UK, a survey for the Money Advice Service by Ipsos Mori's Social Research Institute highlighted the possibility of carers storing up a 'pensions penalty', where they may not have accrued adequate entitlements to state, occupational or private pensions. "This was raised as a particular issue in the qualitative research with carers close to retirement concerned about how they will manage financially and whether they will be able to make the most of the time available to them", the report reads.<sup>65</sup>

A similar survey conducted in Canada revealed that Canadian baby boomers are concerned about caring for their parents and financially assisting their adult children. One quarter of baby boomers are concerned about their parents' health and how it will impact them in retirement. Meanwhile, 16% said that helping their children financially is one of their objectives. Yet only 40% of younger baby boomers feel prepared for their retirement.<sup>66</sup>

## Periods of unemployment

Periods of unemployment are another factor which can hit retirement incomes. The OECD notes: "Unlike their parents' generation, many of today's workers face growing job insecurity and the need to continuously update their skills. The standard employment relationship has given way to more flexible, but often more precarious, arrangements, such as part-time work, fixed-term contracts and various forms of self-employment."<sup>67</sup>

It's an important issue. On average, people without a job suffer a 1% drop in their old age pension for every year they spend unemployed.<sup>68</sup> As the OECD says, the state must tread a delicate balance between supporting people who are involuntarily unemployed to ensure they do not lose out on their pensions, whilst avoiding discouraging people from seeking jobs by providing overly generous pension contributions to the unemployed.

The self-employed can also be easily disenfranchised from saving into a pension, leading to poor retirement outcomes. This issue is set to become more and more important as the structure and fabric of our working lives changes. "I think as we become more individualistic and the workforce becomes more flexible – self-employed, people working from home, etc. – there still needs to be a system that picks up people who aren't part of the full-time workforce," says Mercer's David Knox.

In the UK, the Pensions Policy Institute points out that a mere 22% of self-employed men were saving into a pension in 2013, compared to 62% in 1997.<sup>69</sup>

"Countries like Chile, Australia and Mexico had systems which did not cover the self-employed. Now they are trying to extend compulsion into the self-employed because they find that, broadly speaking, 15-20 % of the country are not saving enough," reports the OECD's Pablo Antolin.

Knox calls the exclusion of Australia's self-employed population from superannuation "a major omission". He also highlights India and China, with their relatively informal working arrangements, as a challenge to any conventional pensions system.

"A pensions system has traditionally built upon a fairly formal labour market. Where you have half the population working in the fields or in small shops in a very informal way, it makes it much more difficult. Having said that, India is certainly working on technology and saying 'Well we can conduct our pensions system with our mobile phones,'" explains Knox. "So maybe we don't need the formality that we have traditionally had. Obviously it takes time and education and cultural change, but I think that is a little bit of a hint of where we are going."

<sup>65</sup> *The Sandwich Generation: An exploration of the affective and financial impacts of dual caring*, Ipsos Mori for the Money Advice Service, 2013.

<sup>66</sup> *Cost of "Boomer Sandwich" generation may impact retirement cash flow: Scotiabank retirement survey*, Reuters, 2014: <http://uk.reuters.com/article/idUKnMKWZ5dVa-1f2+MKW20140626>

<sup>67</sup> OECD (2015), op. cit. p74.

<sup>68</sup> OECD (2015), op. cit. p75.

<sup>69</sup> *The under-pensioned*. Daniela Silcock, Shamil Popat and Tim Pike. The Pensions Policy Institute. March 2016. ISBN 978-1-906284-39-8. See chart 11, p50.

## DISENFRANCHISED FROM THE UK PENSIONS SYSTEM

The Pensions Policy Institute (PPI) notes that disparities in UK pension incomes have reduced over the last decade, due to state and private pension reforms. Although the pensions gap is reducing, more should be done.<sup>70</sup>

Specifically, lower levels of retirement income are typically tied back to a lifetime of lower earnings. Who are most likely to be disenfranchised from saving? Disabled people, Pakistani, Bangladeshi and Chinese people, carers and women are more likely to be unemployed than people from other groups, the PPI notes.<sup>71</sup>

“Because of the diverse range of issues underlying these differences, tackling them would involve a joint effort from government departments, employers, social services, regulatory bodies and community support groups”, the PPI notes. The PPI found that women and people from ethnic minorities receive 13% to 25% less, on average, from state pensions.<sup>72</sup>

The government has taken some positive steps – in particular, the introduction of a single-tier, flat-rate state pension for those who reach State Pension Age on or after 6th April 2016 – to ameliorate these discrepancies. However, this is only paid in full to those with a 35-year national insurance contributions (NICs) record, with a pro rata payment being made to those with a minimum 10 year NICs record. The government has a difficult balance to strike here. As explained in previous chapters, it must give people ample warning before making substantive changes to the system. At the same time, policymakers should act to end inequitable situations where it sees them.

One important area where the government should act to mitigate inequitable outcomes is in auto enrolment. The PPI points out that auto enrolment’s current structure disadvantages people from already under-pensioned groups.

For instance, 32% of women do not meet the eligibility criteria for auto enrolment, compared to 16% of men. Almost a quarter (23%) of white workers do not meet the eligibility criteria for auto enrolment, but the figure is much higher for Pakistani workers (32%) and Bangladeshi workers (33%).

In addition, as the PPI points out: “Those with multiple jobs who earn above £10,000 per annum from combined income will not be eligible for automatic enrolment if they earn less than £10,000 per annum from any of their jobs individually.” This clearly disadvantages those with part-time jobs and in a world where part-time work is increasingly normal, feels out of step with societal changes. It also puts women at a further disadvantage, as women are more likely to hold a part-time job than men.<sup>73</sup>

## In pensions we trust

***“There are three central questions people want to know about their pension. These are: ‘What happens to my money? Is my money safe? What will I get in the end?’”***

A final societal factor which could stymie a good retirement income is the issue of trust in the pensions system. Without trust, people are likely to disengage with pensions and actively decide to opt out of the system.

<sup>70</sup> *The under-pensioned*, op.cit. pp10-11.

<sup>71</sup> *The under-pensioned*, op.cit. Chapter 2.

<sup>72</sup> *The under-pensioned*, op.cit. Chart 4, p36.

<sup>73</sup> As the Pensions Policy Institute points out, 490,000 people held two or more jobs in the UK in 2014/15; 340,000 of those were women.

As the full scale of the financial crisis unravelled, banks were bailed out and questions were asked about quite how so much systemic risk was allowed to exist unquestioned, the public was left disillusioned. 'Investment' became synonymous with 'greed', 'corruption' and 'casino capitalism'.

People around the globe distrust financial services. The industry is consistently rated the least trustworthy in PR firm Edelman's annual survey of trust.<sup>74</sup>

A research report by the UK's National Employment Savings Trust (NEST) observes: "Stories of people losing all their money endure in the collective public memory. In our focus groups people still referred to Robert Maxwell and his role in the collapse of the Mirror Group pension scheme. It seems that for many consumers 'Maxwell' is the biggest brand in pensions. People also tell stories of relatives or acquaintances that 'lost' money in a company pension or ended up with a disappointing outcome after years of saving. This has created a consensus that pensions are insecure and open to corruption and mismanagement..."

"As well as eroding consumer confidence, these stories leave people confused as to how pensions work. Poor investment performance is associated with embezzlement, and market downturns are blamed on bad fund management."<sup>75</sup>

NEST also found that people who had never saved into a pension before often did not realise that their money would be invested. There was a common sense that pension contributions should be treated with more caution than other types of investments. "Where there is apparent understanding that money in a pension is money invested, there's still shock and incredulity that the risks in pensions and investments are one and the same", the research said.

How to restore people's trust in the system is a huge issue. NEST's qualitative research gave some insights which could prove instructive. Many people told NEST they would feel reassured by a pension provider that was 'honest', 'caring', and whose staff are 'salary, not commission-based'.

When communicating with savers, it's important to frame that information carefully. According to NEST's research, people tend to engage with pension communications when they are concerned. "Communications need to reassure, not just inform", NEST advises.

There are three central questions people want to know about their pension, according to NEST. These are: 'What happens to my money? Is my money safe? What will I get in the end?'

NEST has developed an approach to communications accordingly, and emphasises the importance of clearly communicating the concepts of lifestyling and diversification, which implicitly deal with risk without sounding alarming. Its key principles include: 'Be a safe pair of hands', acting transparently and displaying integrity.

Another is 'Show you have a plan'. According to the report: "NEST research shows that while members don't expect NEST to be able to make everything okay, they want to know that NEST is aware of the risks and has a plan to reduce them. NEST can do this by explaining the importance of a diversified portfolio and showing members the ways that NEST's investment team analyses and manages risk."

NEST is to be commended for considering its approach to member communications so carefully. Only by bringing savers on-side, instead of estranging them with unfamiliar language and concepts, will they trust the system with their money.

<sup>74</sup> Edelman Trust Barometer 2016: <http://www.edelman.com/insights/intellectual-property/2016-edelman-trust-barometer/executive-summary/>

<sup>75</sup> *Improving Consumer Confidence in Saving for Retirement*, the National Employment Savings Trust.

## CHAPTER 4: PENSION REFORMS UNDER THE SPOTLIGHT

### KEY POINTS

- The nature of retirement is changing as people phase gradually from work into retirement.
- The pensions burden on governments and employers has variously been reduced by cutting tax deductions on pension contributions, increasing taxes on retirement income, reforming the indexation of public pensions, raising defined benefit contribution rates without improving benefits and reducing scheme administration costs.
- Savings levels have been boosted by increasing the scope of voluntary private pension systems, awarding pension credits, reducing scheme management costs, and scheme consolidation.

### INTRODUCTION

In recent years, governments across the world have been trying to strike the most intricate of balances. They must create pension systems which are affordable for employers, savers and the state, whilst also adequate to sustain retirees through their twilight years.

### RAISING THE RETIREMENT AGE

***“Far from leaping off a cliff edge from earning a full salary to earning nothing, for many people, retirement will morph into a gentle slope.”***

The OECD, summarising trends in global reforms, reports that the most popular reform has been to increase the minimum and/or main retirement age. As we observed in chapter 1, employment rates drop off substantially after the ages of 55-59. Indeed, in 2014, when the employment participation rate of the working age population across all OECD countries was 67%, for those aged 60-64 the employment rate dropped to 44% and for the 65-69s, it was 20%.<sup>76</sup>

As we noted in chapter 2, so long as people are given sufficient notice, increasing the retirement age is a simple way to adjust the system to take longer life expectancy into account. Yet the OECD's figures show that for most countries there is still a way to go in terms of encouraging people to work for longer, shifting social norms in the process. Of course, with improvements in health longevity lagging longevity improvements per se, limiting longer periods in retirement by increasing the state pension age is often compromised by physical and mental impediments to health.

The nature of retirement is changing. As we live longer and healthier lives, choosing to embrace the advent of the portfolio career or multiple careers in a lifetime and use technology to remain connected while working remotely, people are more likely to phase gradually from work into retirement. Rather than the static retirements of old, retirement will become an opportunity for people to turn a hobby into a business venture, or phase from full-time to part-time employment.

Far from leaping off a cliff edge from earning a full salary to earning nothing, for many people, retirement will morph into a gentle slope. Therefore, it is encouraging to see that some countries are embracing flexibility in the way that people combine their salaries with their pensions. Methods vary, from the carrot to the stick approach to incentivising people to remain in the workforce for longer.

Australia is one country taking the carrot approach. It recently strengthened its incentives for employers to hire and retain older workers, the OECD reports. Norway is another. The OECD says: “In Norway, new requirements for occupational pensions to offer a more flexible retirement age from age 62 to 75 at partial withdrawal ranging from 20% to 80% will enable more people to accommodate further work and pension withdrawal according to their preferences.” Spain is a third; it is now possible to simultaneously work and take pension benefits.<sup>77</sup>

<sup>76</sup> OECD (2015), op. cit. p22 and p160.

<sup>77</sup> OECD (2015), op. cit. p26.

Of course, the UK's pensions freedoms also give people more flexibility about how they live, work and take their pension; the worry is that people will take all their money at once, or run out of cash too early.

Taking a more stringent approach is Austria, where annual penalties for each year of early pension withdrawal will soon increase from 4.2% to 5.1% for people born in 1955 or later.<sup>78</sup>

## INDEXATION REFORMS

Another reform which has been implemented in a number of countries is to cut public pension benefits via reforming the underlying indexation methodology. This is typically more politically palatable than straightforward cuts, although that is not always the case. In April 2015, the Italian Constitutional Court ruled that the government's partial benefits freeze of benefits above €1,500 (£1,163/\$1,686) in 2012 and 2013 was unconstitutional.

According to the World Economic Forum, the Italian government introduced a temporary block to pension indexation in 2012 and 2013, for all pension entitlements that exceed three times the minimum. However, the court ruled that a block, however temporary, violates the principles of proportionality and equality.

The Italian example proves that reforms to pensions indexation calculations can have a massive impact on a country's balance sheet. As a result of the ruling, the government will have to pay 4.5 million pensioners an estimated €18bn. This is just the headline cost; because of the ruling, the Italian government will have to change its methodology for future benefit calculations too, meaning increased future costs, too. Had the reform proceeded uncontested, this clearly would have represented a huge saving for the Italian treasury. As it is, the ruling will have a huge impact on Italy's budget deficit – the World Economic Forum estimates it could take the 2015 deficit from 2.6% of GDP forecasted by the government to 3.6%.<sup>79</sup>

Interestingly, the UK has bucked the trend by applying "triple lock" indexation to state pensions. Applied at the higher of 2.5%, consumer price inflation and nominal wage growth, this arguably creates an unsustainable burden on public pensions spending.

Elsewhere, the OECD notes that Australia has tightened its means testing for its Age Pension. The changes take effect from January 2017 and will result in winners and losers.<sup>80</sup> Meanwhile, Spain will adjust its state pension in line with life expectancy every five years from 2019.

## A TAXING ISSUE

Increasing taxes, reducing tax deductions and raising contribution rates in defined benefit (DB) systems without improving benefits, have all been popular changes noted by the OECD in reducing the pensions burden.

Countries have approached pensions taxation in a variety of ways. One way of generating additional revenue is to tax retirement income according to a means test. "In Finland, pensioners have paid an extra tax of 6% on pension income exceeding €45,000 since 2013," observes the OECD.<sup>81</sup> Meanwhile, in New Zealand, the government decided to abolish the kick-start subsidy for each new KiwiSaver account in May 2015, netting them a saving of around 1% of public pensions expenditure over the following four years.

While tax relief is typically harnessed to encourage people to save more into their pensions, some countries have started limiting these tax incentives. For example, in Ireland, tax relief on private pension contributions were reduced for high income earners in 2014, while in the Netherlands and the UK, tax relief on pension contributions is capped.

<sup>78</sup> OECD (2015), op. cit. pp25-26.

<sup>79</sup> *What are the implications of Italy's pension ruling?* World Economic Forum, 26 May 2015. [www.weforum.org/agenda/2015/05/what-are-the-implications-of-italys-pension-ruling](http://www.weforum.org/agenda/2015/05/what-are-the-implications-of-italys-pension-ruling)

<sup>80</sup> The Australian Age Pension is particularly generous, offering a basic pension of more than 25% of average earnings in addition to assistance with many older age expenditures. However, New Zealand has the most generous basic pension at over 40% of average earnings. See OECD p50.

<sup>81</sup> OECD (2015), op. cit. p22.

Tax relief is a hotly debated subject in the UK. Rumours that the UK government had decided to abandon possible wholesale reforms to its tax relief system recently made national headlines. In 2015, the government consulted on a wide range of potential reforms. The rumoured winning proposal was to abolish upfront tax relief: workers would pay taxed income into their pensions as they saved, instead of paying tax on their income taken in retirement. This has been termed a pensions ISA (individual savings account).

Before the news was leaked, eminent figures in the pensions industry spoke out candidly about the threat they believed the reforms would pose.

The former UK pensions minister Steve Webb commented: “A pension ISA steals billions of pounds in tax revenues from the next generation who will need the money to fund the public services of an ageing society. And if the Chancellor [the Finance minister] opts for a low flat-rate of tax relief, he will be stealing billions of pounds today from the support we give to hard-pressed savers.”

The UK example shows that despite the complexity of the issues involved, threats to tax relief can prompt highly emotive reactions.

## REDUCING THE ADMINISTRATION BURDEN

A pensions cost that has been targeted by Pay As You Go (PAYG) public DB schemes across a number of countries is administration. The OECD notes that administration costs are often higher in DB schemes, where the connection between costs and outcome is less directly quantifiable than in defined contribution (DC) schemes. A number of countries are seeking greater efficiency through administration mergers, the adoption of new technology or regulatory measures.

The OECD reports that Greek government-sponsored auxiliary pension funds have been merging since 2011. Meanwhile, Spain is reducing its administrative burden by enabling the General Social Security Treasury to bill employers directly for pensions contributions, rather than having employers calculate the employee’s contributions, which will reduce the administrative burden placed on employers. Spain has also created a new public body to oversee financial sustainability – including the country’s pensions burden. The Independent Agency for Fiscal Responsibility was created in November 2013.<sup>82</sup>

## BOOSTING SAVINGS LEVELS

Several countries decided to increase the scope of their voluntary private pension systems. Auto enrolment is the obvious example, and, as noted earlier, Ireland is planning to introduce a similar system. Canada, as we observed in chapter 2, has also introduced a new type of retirement savings plan, the Pooled Registered Pension Plan, in some provinces. It is softer touch than the UK; it is voluntary for employers, but is also based on auto enrolment principles.<sup>83</sup>

Yet at the same time, elsewhere, voluntary systems are closing. In 2014, the Czech Republic decided to close its second pillar of voluntary individual accounts.

To some extent, political U-turns were to blame for the system’s failure, showing the importance of a broad degree of political consensus and a long-term mindset in pensions policymaking. At the time, the magazine *Investment & Pensions Europe* reported: “[Prime minister] Sobotka’s pre-election warnings that his party would scrap the system if it won undoubtedly contributed to the low take-up, and with some providers in the long-standing third pillar declining to participate.”<sup>84</sup>

The OECD also notes that some countries awarded retroactive pension credits, or found other ways of reducing the impact of missing years of contributions on pension savings. This allows people who take career breaks – to raise children, for instance, or who suffer an extended period of unemployment during a recession – to mitigate the adverse of such a break on their pensions.

<sup>82</sup> OECD op. cit. pp26-27.

<sup>83</sup> OECD op. cit. p28.

<sup>84</sup> Czech second pillar pension system to close by January 2016, *IPE*, 13 November 2014. [www.ipe.com/news/regulation/czech-second-pillar-pension-system-to-close-by-january-2016/10004774.fullarticle](http://www.ipe.com/news/regulation/czech-second-pillar-pension-system-to-close-by-january-2016/10004774.fullarticle)

According to the OECD: “In France, the accrual of pension entitlements during periods of maternity leave, professional training, tertiary education and unemployment will become more generous. In Japan, workers will be able to make up gaps in their contribution record by paying additional voluntary contributions. In Germany, the introduction of credits for children born before 1992 (i.e. the mothers’ pension) will increase current and future pension benefits retroactively.”<sup>85</sup>

Some governments have sought to boost pensions by increasing DC saving rates. Mandatory saving rates will increase from 9.5% to 12% in 2025 for Australians. Auto enrolment savings rates are also set to increase over time in the UK from April 2018.

The OECD also notes that in a number of countries, management costs have been lowered and improvements have been made to the security of pension investments.<sup>86</sup> Pensions regulators worldwide must strike a delicate balance between cost, innovation and choice on behalf of the often disengaged end investor. In the UK, industry participants and observers will be well aware of the ongoing debate around costs and charges, which culminated in a 0.75% cap on auto enrolment default fund charges in the accumulation phase of savings.

The UK is not the only example of this trend. How else to deliver good value? Economies of scale are one answer. One senior figure in the Danish pensions industry is absolutely convinced that small pension funds can never obtain good value. “Tiny little pensions trusts will obviously have absurd costs.”

Chile’s Planvital, the administrator which won the tender to manage DC accounts for new entrants, will charge an annual fee of 0.47%. Previously, the fee was 0.77%. Australia is making efforts towards greater transparency by introducing a new, simple DC scheme called MySuper in 2014. MySuper will offer a “more uniform, easier to compare set of products”, the OECD reports.<sup>87</sup>

As noted in chapter 1, in the Netherlands, the number of pension funds has significantly dropped in recent years, from around 1,000 in 2000 to less than 400 in 2015. “Most smaller funds have been absorbed by their bigger counterparts, while some were liquidated. For corporate funds, the mandatory consolidation with their sponsor’s balance sheet was a key motivation to change the setup. Another important cause was the introduction of much stricter requirements for trustees which made it more difficult to find the right people. A final cause was the increased administration and service costs”, explain Dutch experts Eduard Ponds and Onno Steenbeek.<sup>88</sup>

Overall, the reforms described above demonstrate that there are key trade-offs to be made between cost and choice in order to achieve the best possible results for savers. As the OECD explains: “For example, in a system where there is a weak link between contributions and benefit payments, such as in defined benefit schemes, increases (reductions) in pensions deteriorate (improve) financial balances.”<sup>89</sup>

Accordingly, the countries which achieved a successful balance tended to take a combination of measures. “This for example happened in Australia where the contribution rate is planned to increase as is the retirement age”, the OECD notes.<sup>90</sup>

<sup>85</sup> OECD (2015), op. cit. p29.

<sup>86</sup> OECD (2015), op. cit. pp18-19.

<sup>87</sup> OECD (2015), op. cit. p30.

<sup>88</sup> *Towards a New Pensions Settlement: The International Experience*, op. cit. pp44-45.

<sup>89</sup> OECD (2015), op. cit. p19.

<sup>90</sup> OECD (2015), op. cit. p19.

## CONCLUSIONS AND RECOMMENDATIONS

What does an ideal pensions system look like? The answer will depend on the rich fabric of an individual country's history, society, prevailing political ideology and economic situation. Indeed, as we noted in chapter 1, the World Bank acknowledges that owing to countries' differing economic, social and cultural factors, there can never be a definitively and universally perfect pension system that applies to all countries at any one time.

However, it is possible to identify some enduring principles which will have universal application. The CFA Institute, in collaboration with Mercer, published a 2015 report which did just that.<sup>91</sup>

### HERE ARE THE TEN PRINCIPLES OUTLINED IN THE CFA INSTITUTE'S *AN IDEAL RETIREMENT SYSTEM, MARCH 2015:*

- 1.** The government must establish clear objectives for the whole retirement system, including the complementary roles of each pillar, and incorporate the provision of a minimum income to alleviate poverty amongst the aged population.
- 2.** A minimum level of funding should be made into a pension system for all workers with contributions by employers, employees and the self-employed, as well as for those of working age who are receiving certain forms of income replacement. In effect, this means every worker will have a retirement account with an entitlement to future benefits.
- 3.** There should be cost-effective and attractive default arrangements, both before and after retirement, for individuals who do not wish to make decisions.
- 4.** The overall administration and investment costs of each pension arrangement should be disclosed with some competition present within the system to encourage fair pricing.
- 5.** The retirement system must have some flexibility as individuals live in a range of personal and financial circumstances. This flexibility includes recognizing that retirement will occur at different ages and in different ways across the population.
- 6.** The benefits provided from the system during retirement should have an income focus but permit some capital payments or withdrawals during retirement, but without adversely affecting overall adequacy.
- 7.** Contributions (or accrued benefits) at the required minimum level must have immediate vesting and portability. These accrued benefits should only be accessible under certain conditions, such as retirement, death or permanent disability.
- 8.** The government should provide taxation support to the funded pension system in an equitable and sustainable way, thereby providing incentives for voluntary savings and compensating individuals for the lack of access to their pension savings.
- 9.** The governance of pension plans should be independent from the government and any employer control.
- 10.** The pension system should be subject to appropriate regulation including prudential regulation of pension plans, communication requirements and some protection for pension scheme members.

<sup>91</sup> *An Ideal Retirement System*, CFA Institute, March 2015. [https://www.cfainstitute.org/learning/products/publications/contributed/Pages/an\\_ideal\\_retirement\\_system.aspx?WPID=Report&PageName=RS](https://www.cfainstitute.org/learning/products/publications/contributed/Pages/an_ideal_retirement_system.aspx?WPID=Report&PageName=RS)

In addition to the above, we also noted, in chapter 1, those desirable adequacy, sustainability and integrity characteristics suggested by the MMGPI that should generate better financial outcomes at and in retirement, namely:

#### **Adequacy**

- A minimum pension based on a “reasonable percentage” of median earnings for those on a low income
- A 70+% replacement rate for a median earner
- 50+% of pension benefits to fund an income stream in retirement

#### **Sustainability**

- Private pensions coverage of 70+% of the working age population
- Pension assets in excess of 100% of GDP (with 175% of GDP seen as the aspiration) to fund future pension liabilities and help address intergenerational inequality
- 65+% of those aged 55 to 64 in employment to fund a higher standard of living in retirement and reduce the time spent in retirement

#### **Integrity**

- Strong regulation of private pension plans
- Clear, timely and practical member communications with projections of retirement income
- Clear funding requirements for DB and defined contribution (DC) schemes

## **WHAT WOULD WE ADD?**

The above principles and characteristics provide an excellent framework for any country which is seeking to design a first class pension system. Following our sweep of the globe in search of specific examples of good practice, in addition to the above, we think the UK's pension system, in particular, could be improved by the incorporation of the following specific five characteristics:

### **1. A long-term approach**

In recent years, UK pensions policy has suffered from political short-termism, with laudable long-term pension policy objectives being compromised by the more immediate focus of financing the country's fiscal deficit. Indeed, largely unhelpful political tinkering with pensions has become a somewhat permanent feature of government policy, resulting in greater complexity and uncertainty. This comes at a time when the country's engagement with pensions continues to waver. This has led many pensions experts to call for a return to consensus policymaking. Most recently this call was made in David Blake's Independent Review of Retirement Income: the very headline established the need for a consensus around retirement income.

Pension freedom and choice takes the UK out on a stark ideological limb, putting it on a very different trajectory to the rest of the world. Whether, as UK Chancellor of the Exchequer [the Finance minister] George Osborne claimed in his March 2016 Budget, the UK's economic policy will be perceived as “[Leading] the world with long-term solutions to long-term problems” in years to come is yet to be seen.

Most international experts we spoke to were of the opinion that freedom and choice leaves too much power in the hands of savers who do not have the appetite or capacity to make informed decisions. Somewhat ironically, countries like Australia, which implemented freedom and choice over 20 years ago, aspire to create a system which resembles the UK's annuity market, to improve standards of living in retirement. Indeed, the UK government's decision to effectively dismantle compulsory annuitisation was viewed with great surprise and considerable reservations by overseas observers, not least the OECD and the MMGPI.

Prior to the introduction of freedom and choice, many people in the UK struggled to decide which annuity to buy – or simply defaulted into whatever was available from their provider. The regulator, the Financial Conduct Authority, revealed that 60% of consumers were not switching providers when they bought an annuity, although 80% of those consumers could have obtained a better deal on the open market.<sup>92</sup> If consumers struggled to make an active annuity choice, how likely are they to make a good – or an active – decision, faced with boundless choices? (See recommendation five).

The Chancellor shows no signs of stopping his interventions in the UK pensions system. More recently, in the March 2016 Budget, a Budget positioned as “putting the next generation first”, the Chancellor announced the creation of a new Lifetime ISA (LISA) to promote long-term saving amongst the 18 to 40 age group, many of whom comprise the under-pensioned. Through an annual government contribution, a LISA will effectively provide basic rate tax relief on up to £4,000 of annual saving, alongside tax-free growth and, subject to stringent conditions being met, tax-free withdrawals.

While any efforts that encourage the UK population to build up more savings are to be commended, it's also important to have a strategy and stick to it. Experts have warned that an unintended consequence of LISAs could be to encourage people to opt out of auto enrolment, thereby causing them to miss out on valuable employer contributions. The introduction of LISAs may also herald the implementation of a Pensions ISA, which would tax people on the way in but allow tax free withdrawals on the way out.

“In this Budget we choose to put stability first”, said George Osborne in his Budget speech of March 2016. The irony of this statement will be apparent to anyone who is watching UK pensions policy, whether domestically or overseas.

## 2. A fairer system

At the moment, women, part-time workers, certain ethnic groups, and carers are among the groups to be disadvantaged by the configuration of the UK pension system. The Pensions Policy Institute's research findings from its 2016 report, *The Underpensioned*, bear repeating: women and people from ethnic minorities receive 13% to 25% less, on average, from state pensions. In addition, 32% of women do not meet the eligibility criteria for auto enrolment, compared to 16% of men. How best to bridge the gap? Perhaps the Danish system could provide some learnings. Women often take breaks from the employment market to raise children; carers may also take breaks from the workforce. In Denmark, while people are unemployed, unemployment insurance (or the municipality if the person is not insured) not only covers second pillar ATP contributions, but pays them at a double rate, as we noted in the executive summary and chapter one of this report. Generous provisions are also made for pensions during maternity or paternity leave.

Clearly, this level of generosity has a cost attached. Denmark is consistently one of the most generous countries in Europe when it comes to public social spending, while the UK ranks at the lower end of the middle-spending countries in the OECD.<sup>93</sup>

Of course, savers must also take responsibility for their financial futures. The UK government has already taken some important steps towards a fairer pensions system. For instance, it is making the state pension age consistent for men and women, and it will link the state pension age to life expectancy from 2028. John Cridland, the former director general of the Confederation of British Industry, is heading a review of the existing state pension age system, which is due to publish its recommendations in 2017.

<sup>92</sup> *Thematic Review of Annuities, TR14/2, 14 February 2014, Financial Conduct Authority.*

<sup>93</sup> *Social Expenditure Update, November 2014, OECD.*

Whatever policy action the government chooses, it's clear that social norms around retirement age must also change. Working beyond the age of 65 for many must become the norm, rather than a perceived hardship. How have other countries embraced this? In chapter 4, we noted that approaches vary, from carrot-style incentives to harsher, stick-based approaches. Australia recently strengthened its incentives for employers to hire and retain older workers. Conversely, in Austria, annual penalties for each year of early pension withdrawal apply.

There are some clear, short-term wins the government could introduce to make pensions fairer for all of society. The most obvious is to widen the scope of auto-enrolment to include the self-employed, and to change the rules so that anyone earning over £10,000 is auto-enrolled, even if their income comes from multiple sources. Getting the administration right will be a challenge – but government and industry owe it to tomorrow's savers to meet it head on.

### 3. A more adequate system

Turning now to adequacy, there are a number of steps the government could take to improve pensions outcomes. Higher contribution rates – as are evident in Australia, Denmark, the Netherlands, et al. – are an important part of the answer.

Ideal gross replacement rates are in the order of 65-80%, according to the CFA, with lower income earners aspiring to a higher replacement rate. MMGPI judges an adequate system to provide a 70+% net replacement rate for a median earner. There are no short cuts to achieving these types of replacement rates – and as we have already noted, it is unfortunate that the UK government shows no sign of acting to lay the foundations for higher contribution rates once auto-enrolment is more established.

The UK has a savings problem. Household savings rates are at a 50-year low of 3.8%, according to the Office for National Statistics.<sup>94</sup> No wonder: wage growth is sluggish, with growth in the three months to April 2016 the least generous in nearly six years.<sup>95</sup>

It's clear that the pensions industry will need to find clever new ways to encourage people to put aside their hard-earned cash. Encouragingly, technology is fast developing which could play a vital role in encouraging people to save more for their retirement. The app Qapital allows users to set a financial goal, and then set automatic spending rules to help them work towards it. For instance, you can instruct it to put £2 aside every time you buy a coffee.

Government and industry should also harness behavioural techniques such as auto-escalation to improve savings levels (see recommendation four).

Investment also plays a crucial part in improving outcomes. One interesting phenomenon is Chile, Peru and Colombia's peer group approach (see Chile case study, chapter one). Pension schemes have to achieve a minimum investment return, relative to their peer group. If the scheme fails to achieve the return, they need to cover the performance shortfall from their balance sheet. If impossible, the scheme is liquidated and the government must make good on the shortfall.

This is almost a step on from fiduciary duty – it requires pension schemes to put their money where their mouth is. As a result, schemes are highly motivated to rigorously monitor investment performance. That said, there are questions to be answered before this sort of approach is adopted in the UK. For instance, could this approach lead to the pursuit of an overly short-term investment agenda, selling stocks when they underperform when in fact pension funds should be patient, long-term stewards of savers' money?

<sup>94</sup> Office for National Statistics, Economic Review, May 2016: <https://www.ons.gov.uk/economy/nationalaccounts/uksectoraccounts/articles/economicreview/may2016#alternative-savings-ratio>

<sup>95</sup> UK April pay data points to lowest wage growth since 2010, Reuters, April 2016: <http://uk.reuters.com/article/uk-britain-employment-xperthr-idUKKCNOXIOGG>

## 4. An engagement strategy which has behavioural principles at its heart

### **Most people are ill equipped to make informed decisions**

Although not a key focus of this paper, it is evident that most people are woefully ill equipped to determine how best to achieve a good retirement outcome, given the complexity and multiplicity of the decisions to be made; the alarmingly low level of basic numeracy and financial literacy amongst the UK adult population; the lack of frames of reference and a paucity of guidance to evaluate complex choices; and a widespread unwillingness or inability to pay for financial advice. This is compounded by inertia and a lack of trust. Consequently, there remains a deep seated reluctance to engage with pensions and retirement outcomes.

Therefore, it's incumbent on policymakers, regulators and the pensions community not to leave people to their own devices when it comes to making the right choices for their retirement.

Indeed, this lack of engagement also emanates from deeply engrained behavioural biases. Acting as a barrier to informed decision making, these biases yet further compound sub optimal savings levels, inappropriate investment decisions and compromise the ability to successfully navigate a multitude of potentially hazardous risks at and in retirement. To counter these, reasonably simple behavioural interventions, that consider the emotional, cognitive and social factors that impact financial decision making, can be used by policymakers and the pensions community alike to help people better help themselves pre, at and in retirement. These can variously harness the inertia of the disengaged or address many of the impediments to good, informed decision making for those willing and able to make an active decision.

### **Using “nudges”**

Policymakers have increasingly become more open to applying behavioural insights to public policy, using “nudges” in particular to move people gently towards a positive outcome, rather than scaring or pressurising them into a course of action. One particularly successful nudge has been to use the “reverse default” in auto enrolment to utilise the inertia associated with getting people to save into a pension, by requiring them to opt out, rather than opt in. After all, the foundation of a good financial outcome at retirement starts with saving sufficient throughout one's working life, ideally from an early age. However, the minimum contribution rates of workplace pension schemes, particularly auto enrolment workplace pension schemes, are widely perceived by members as “target” saving levels with the latter typically seen as having been endorsed by the government as being adequate. Therefore, the UK government should anchor auto enrolment pension savers to a contribution rate which will provide them with a genuinely realistic probability of securing a comfortable retirement.<sup>96</sup> Moreover, while it is right to ease new savers into the pensions habit gently, the government should be putting plans in place now for the auto-escalation of contributions.

Formulated by behavioural economists Shlomo Benartzi and Richard Thaler in 2004,<sup>97</sup> and originating from the same behavioural school of thought as auto enrolment, auto-escalation enables DC savers to commit today to paying increased contribution levels only in the event of receiving future pay rises. By not having to pay any money today and not experiencing any reduction in their current take-home pay, the much reduced costs today of pursuing this action are better aligned with the benefits that will ultimately accrue.

Indeed, the original 2004 research showed how, by signing up for the auto escalation of contributions, members very quickly achieved contribution rates in excess of those members who chose instead to follow the advice of a financial adviser for a one-off rise in contributions. So, whereas a one-off increase in contributions became the new default for the latter group, a

<sup>96</sup> While current auto enrolment contributions have been set at a level that doesn't materially reduce an individual's earnings, thereby minimising opt outs, these contribution rates will automatically increase to more realistic (though arguably still inadequate) levels in 2018 and 2019. It is acknowledged that in the current low wage growth environment this rapid increase in contribution levels could be problematic.

<sup>97</sup> Richard H. Thaler, University of Chicago and Shlomo Benartzi, University of California, Los Angeles. *Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving*. *Journal of Political Economy*, 2004, vol. 112, no. 1, pt. 2.

constant rise in contributions became the new default for the former. While popular in the US, auto escalation has yet to be introduced in the UK and has been put on the backburner by the UK Pensions Minister until the initial auto enrolment process is completed in 2018.

### **Encouraging greater engagement**

There is also a role for behavioural economics to encourage greater engagement amongst those better able to decide for themselves, by attempting to remove the cognitive barriers to inaction and poor decision making. These include simplifying processes and removing the “hassle factor” associated with taking a course of action (as the merest detail can result in inaction); using novel incentives to make the action attractive; engaging with individuals at those times in their lives when they are most receptive; simplifying and personalising messages – NEST’s eight Golden Rules of Communication are a great place to start; better framing the information people receive, not least in making benefits arising in the distant future more tangible and salient; breaking down the achievement of a complex goal into simple, manageable steps; integrating just-in-time education into the decision making process; employing gamification to simplify and make engagement with complex decisions more enjoyable; and using positive peer comparisons or positive social norms to drive and reinforce better behaviours amongst and within particular groups.

The simple, pragmatic and practical EAST framework (make it Easy, Attractive, Social and Timely), devised by the UK’s Behavioural Insights Team, which harnesses the above features, can be applied to the pre-, at and in retirement stages to dramatically improve savings levels, investment decision making and the management of the key risks faced at and in retirement. However, for the EAST framework or any other behavioural intervention to be effective, it should only be employed with a good working knowledge of the decision problem to be addressed and with the intended intervention having been adequately tested.

Much can be achieved by using user friendly, online tools, such as interactive decision trees that steadily take the individual step-by-step through the myriad of decisions they need to take to arrive at their end goal, and interventions used successfully by other industries, such as traffic lighting by the Food Standards Agency to develop simple and intuitive food labelling to encourage healthier eating.

Another behavioural technique which could encourage people to save is helping them to engage with their future selves by using visual projections. People apply extreme discounting principles when asked to trade off short term gains against long-term ones. Typically, the closer they get to becoming their future self, the more closely they identify with that self, note Hershfield, Goldstein et al.<sup>98</sup>

“To people estranged from their future selves, saving is like a choice between spending money today or giving it to a stranger years from now”, explain Hershfield, Goldstein et al. The authors conducted a series of experiments, showing people rendered images of their future selves and asking them to choose how they would allocate an unexpected windfall. Those who were shown images of their future selves consistently allocated a significantly higher percentage of their pay to retirement.

Ultimately, people need to be properly supported throughout the entire retirement planning and implementation process, by having their options, choices and potential outcomes explained and illustrated to them in a simple, clear, understandable, relevant and practical manner. They also need to be directed to sources of guidance. Only then will they engage with the process and feel empowered to make better and more informed decisions. Which leads us to our next recommendation.

<sup>98</sup> *Increasing Saving Behaviour Through Age-Progressed Renderings of the Future Self*, H. Hershfield, D. Goldstein, et al, *Journal of Marketing Research*, November 2011.

## 5. A guidance and advice system which will help people to make the right choices

The UK government took an important step towards equipping people at and in retirement with the information they need when it created Pension Wise, the free to access guidance service.

However, as we noted in our first recommendation, prior to the advent of freedom and choice, many retirees did not shop around for annuities – which were a far simpler proposition. In the brave new world of infinite choice many people will need advice, not just guidance.

Yet in this fast-changing and litigious landscape, advisers are concerned that there will be repercussions later down the line if they recommend a product or solution to a retiree today that doesn't quite fulfil its intended objectives. We therefore support and echo David Blake's recommendation<sup>99</sup> that regulators should grant safe harbour status to key retirement income products.

Another resource for members is gradually declining. In the past, pension scheme members often had one or several member-nominated trustees to call upon if they had any questions. Those trustees were unable to give financial advice, but could provide general information and further reference points to members who may otherwise have been unsure where to turn. They were an important touchstone.

These days, consolidation is the name of the game. The Pensions Regulator has been supportive of the trend: Andrew Warwick-Thompson, executive director for regulatory policy, said: "The important thing is that 86% of members are now in only 120 schemes, all with 5,000 or more members. This is the point at which we think schemes start to be scalable. So we're pretty supportive of the fact that most people are going into big, well-managed schemes."<sup>100</sup>

Consolidation has many advantages: investment economies of scale and administration efficiencies, among them. Yet with consolidation often comes a more distant relationship between scheme members and those who are responsible for governing the scheme. Member lose their direct access route to someone who will be able to help them – or to point them in the direction of help.

This places more pressure on scheme communications. Regulators have a difficult line to tread between prescription and lack of clarity. We feel they could do more to illustrate where the line lies between presenting information to members and advising them.

<sup>99</sup> *Independent Review of Retirement Income* report, *ibid.*

<sup>100</sup> *DC schemes – prepare to be consolidated*, Pensions Insight, 4th April 2016: <http://www.pensions-insight.co.uk/home/dc-schemes-prepare-to-be-consolidated/14746935.article>

## CONCLUSION

As *Professional Pensions* reported in December 2015, the UK pensions system looks alarmingly fragile in some respects. Speaking at the launch of the OECD's *Pensions at a Glance 2015* report, the OECD's employment, labour and social affairs director, Mark Pearson said: "In fact there are big risks in the [UK pension] system – question marks in some respect, worries in others and unfinished business in still more."<sup>101</sup>

The risks summarised in the *Professional Pensions* article include economic turmoil, a shortfall in private pension coverage, insufficient pension contributions and increased longevity.

The UK government has its work cut out to create a sustainable pensions system which will take its place at the top of the world rankings, alongside Denmark and the Netherlands. There is a long way to go before the UK will be able to genuinely claim to offer world-class retirements to the masses.

In this paper, we hope we have illustrated the multi-faceted approach, principles and characteristics needed to create a pension system which addresses all these issues, not only in the UK but globally. While there is no such thing as a perfect pensions system, policymakers have much to consider and implement if pension systems are to be made sufficiently self-sustaining, equitable for current and future generations and more resilient to economic and demographic headwinds, for good financial outcomes to and through retirement to be achieved. Ultimately, the end goal must be to ensure people can genuinely look forward to enjoying a comfortable retirement. Currently, for most in the accumulation stage, especially those just starting out, this is not a realistic prospect.

<sup>101</sup> *What factors could blow the UK retirement system off course?* *Professional Pensions*, 10 December 2015.







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