

CHAPTER 4

THE GOLD STANDARD — AN A-GRADE SYSTEM

This index has now been prepared for three years and no country has yet attained an A-grade result — that is, an overall index value above 80. Some commentators have therefore raised the following questions:

- What would an excellent retirement income system look like?
- Have you made it too hard?
- Is it possible or unrealistic to receive an A-grade?

This chapter considers these and related questions and shows that it is possible, with appropriate public policy, to develop a framework and system that delivers an A-grade pension system within a developed economy. Of course, it is recognised that no country can suddenly develop such a system but it is valuable to consider the features that are present in a national retirement income system that would have an index value above 80.

Adequacy

The primary objective of any retirement income system is to deliver adequate retirement incomes. The first two indicators of the adequacy sub-index focus on the minimum income level and the median income earner respectively. Higher income earners have a greater capacity to save through their working years and it is therefore more important for the index to focus at the lower end of the income spectrum.

The level of the minimum (or base) income needs to be set at a realistic level that insures aged people against poverty. Recognising that many OECD countries have a basic pension in the order of 20 to 30 percent of the average wage, it is suggested that a base pension of 28 percent³ represents a desirable level of income that offers a level of dignity for the poor in retirement. This level is exceeded by some countries in the index including Brazil, Canada and the Netherlands and would result in a score of 9.

The average net replacement rate amongst OECD countries for a median income earner is 72.0 percent.⁴ It also represents a net retirement income after a full working career that would enable most of these retirees to maintain their living standards in retirement. A replacement rate of 70 percent is therefore considered both desirable and achievable and would result in a score of 10.

The third adequacy sub-index indicator considers the net household saving rate and thereby highlights the important role of savings outside the pension system. Although household saving rates vary enormously, a saving rate of 10 percent is not uncommon and would result in a score of 6. This objective is slightly higher than this year's median saving rate of 8.0 percent with its score of 5.2.

The next four indicators in this sub-index deal with design issues relating to retirement income systems. In each case, the responses depend on legislation.

It is considered that the best retirement income systems have the following features:

- Taxation incentives to encourage middle income earners to make voluntary contributions to funded pension plans, as confirmed by Holzmann and Hinz (2005) who consider that “some preferential tax treatment of standardized retirement–income products as useful.”⁵
- A minimum access (or preservation) age to ensure that the vast majority of pension savings is used for retirement purposes. In view of the increasing life expectancies, this age should be at least 60. Whilst the OECD correctly recognises that there may be occasions when it is appropriate to use part of the savings immediately, they note that “in an ideal world, of course, these assets would be strictly ring-fenced and preserved solely for providing income in retirement.”⁶
- Upon leaving an employer, the member should be entitled to the full value of their accrued benefit. This benefit should be able to be transferred to another pension plan to ensure that its value is maintained in real terms. These requirements relate to vesting and portability of accrued benefits. As the OECD notes, regulation should “promote the protection of vested rights and proper entitlement process” and that “portability rights should be available to members of a pension plan when they separate from service with an employer.”⁷
- A requirement that at least part of the accumulated benefit at retirement be taken as an income stream is consistent with Rocha and Vittas (2010) of the World Bank who state that “it is essential to require a minimum level of annuitization through fixed real annuities.”⁸ They also make the valid comment that “a combination of payout options should ideally be favored, covering different products as well as different payout options over time.”⁹ We recognise that there are many possible forms of income products but suggest that at least 50 percent of any retirement benefit should be taken as income.

3 This level has been selected recognising that half the median income (which is lower than average earnings) is often selected as the poverty line. See for example Dethier et al (2010).

4 OECD (2011), *Pensions at a Glance 2011*, p125.

5 Holzmann and Hinz (2005), *Old Age Income Support in the 21st Century*, The World Bank, p120.

6 OECD (2009b), *Pensions at a Glance*, OECD, p46.

7 OECD (2009d), *OECD Recommendation on Core Principles of Occupational Pension Regulation*, Core Principle 5.

8 Rocha R and Vittas D (2010), *Designing the Payout Phase of Pension Systems*, Policy Research Working Paper 5289, The World Bank, p2.

9 *ibid.*, p29.

It is feasible that a well regulated private pension system can achieve a score of 10 in respect of the first three of these indicators. The income stream requirement can be more difficult and a score of 6.7 is achieved if a 50 percent requirement is imposed.

The final three indicators for the adequacy sub-index consider three different aspects that provide improved retirement outcomes. These are:

- Upon divorce or separation, it is important to allow for each individual's accrued pension benefits in the division of assets.
- Home ownership represents an important factor in providing financial security for many retirees.
- An acknowledgement that some investment in growth assets is likely to provide better outcomes over the longer term.

A full score is achieved in respect of the divorce indicator by many countries and this should be pursued by others to help achieve better retirement outcomes for both individuals involved.

Although home ownership varies greatly between countries, a 65 percent home ownership provides a score of 6.4 which represents slightly less than the median of 6.6 for the 16 countries.

For the last adequacy indicator, a reasonable asset allocation into growth assets is desirable given the long term nature of pensions. A 40 percent allocation would result in a score of 8.5.

The adequacy sub-index value, based on the above suggested values would be 88.4, which exceeds the highest 2011 value of 75.9 achieved by the Netherlands.

Sustainability

As mentioned earlier, it is important that the retirement income system not only produces adequate income but is also sustainable over the future decades, particularly in the context of ageing populations.

The first sustainability sub-index indicator considers the private pension coverage of the working age population. Clearly 100 percent coverage is not practical so the maximum score is achieved with 75 percent coverage.

However coverage in excess of 65 percent is found in several countries and provides a great base for future retirement income security. Coverage at this level results in a score of 8.3.

The second indicator considers the level of pension assets, expressed as a percentage of the country's GDP. Naturally the level of assets depends on the maturity of the system but an objective of 120 percent of GDP represents an attainable goal for a multi-pillar system over the longer term.¹⁰ This outcome achieves a score of 8.0. It is important to note that this indicator represents assets in both the accumulation and pension phases.

The third indicator represents four demographic related topics. Whilst it is recognised that governments can do little, in the short term, to affect their ageing population, it is possible for them to improve the sustainability of their pension system by gradually raising the pension age. A score of 5.5 represents the median score for the 2011 index.

The next indicator considers the level of mandatory contributions that are being set aside now for future benefits in both the public and private sectors. An increasing number of countries have adopted or are considering a level of compulsory contributions in private pensions. Of course, the desirable level of contributions for each country can vary according to their Social Security arrangements, but a minimum level of 8 percent of wages or salaries is considered both reasonable and achievable for many economies. This outcome would score 6.7.

With increasing life expectancies, it is desirable for governments and employers to recognise the need to increase the labour force participation rate at older ages. A 70 percent participation rate for 55-64 year olds¹¹ may appear ambitious for some economies but such an outcome will improve the sustainability of many aspects within the economy, as well as delivering better retirement outcomes. This result would score 7.5.

¹⁰ OECD (2011) notes that three countries have asset-to-GDP ratios greater than 100 percent.

¹¹ This level has already been reached by Sweden with Switzerland, Japan and the USA only slightly below this figure.

The size of a government's debt has been the focus of much attention since the Global Financial Crisis affected many economies. Indeed, as some governments' debts have grown significantly, it has restricted the actions of certain governments in terms of other policies, including the provision of benefits. Whilst there is no 'correct' size of a government debt, it is suggested that in terms of improving future sustainability, a government debt of no more than 40 percent of GDP¹² is desirable. This would mean a score of at least 7.3.

The final sustainability indicator considers whether the pension legislation enables individuals to gradually transition from employment to retirement. This feature encourages longer working careers and reduces the individual's immediate need for retirement income. The gold standard system would require this feature.

The sustainability sub-index value based on the above suggested values would be 73.5, which is exceeded by Sweden and is only slightly higher than the sustainability index value for Australia and the Netherlands. It is noted that this score is lower than the ideal adequacy score. This is not surprising as some of these indicators are difficult to change quickly so a more modest approach has been taken here.

Integrity

The integrity sub-index includes many indicators covering prudential regulation, governance, member communication and protection, as well as costs. Several countries achieved an index value above 80, with the Netherlands scoring 91.4 and the UK scoring 84.5. It is therefore suggested that with appropriate legislation and supervision, it is possible to develop a private pension system that has a strong level of confidence amongst employers, employees and retirees.

A score of 88 for the sub-index represents both an achievable and sound objective for a well-governed and trusted private pension system.

Summary

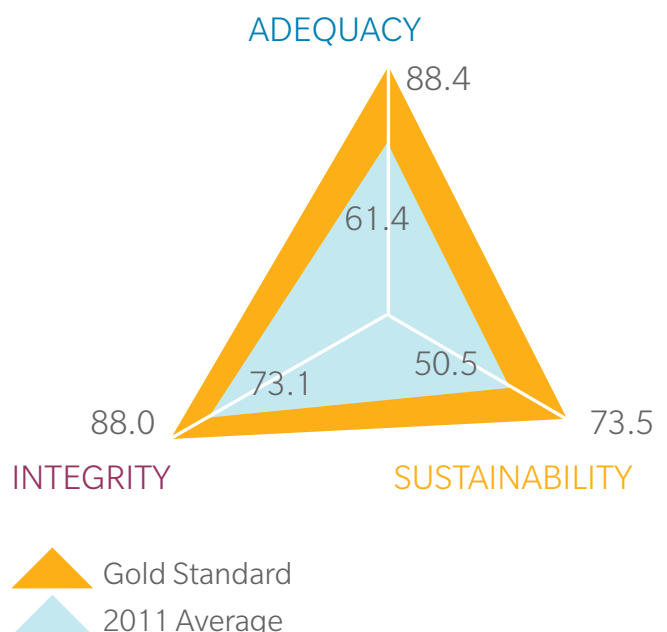
Before concluding, it is recognised that there will be some trade-offs within the pursuit of an A-grade pension system. For example, adequacy could be immediately improved through increases in government-funded age pensions but such a decision is likely to increase government debt and therefore threaten the sustainability of the retirement income system over the longer term. There may also be other tensions with particular indicators that may be related to each other, such as home ownership and saving for retirement.

Notwithstanding these potential trade-offs, the above commentary suggests that a developed economy could enhance and reform its retirement income system and thereby achieve the following index values over the longer term:

- adequacy — 88.4
- sustainability — 73.5
- integrity — 88.0

Such an outcome would represent an overall index value of 83 — very much an A-grade and gold standard system. This system would provide adequate retirement benefits, be sustainable over the longer term and be trusted due to its strong and robust governing structures.

The following diagram highlights the difference between the average value for each sub-index this year and that suggested above by the gold standard values.



¹²The current average for all countries in the index is 58 percent. Excluding the two extremes of Japan and Singapore the average becomes 56 percent.