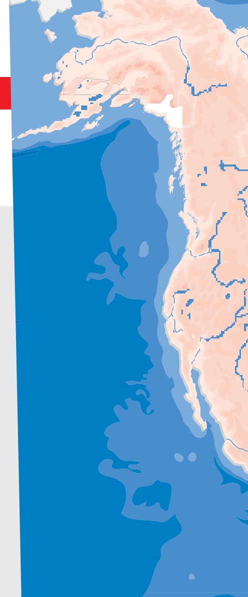
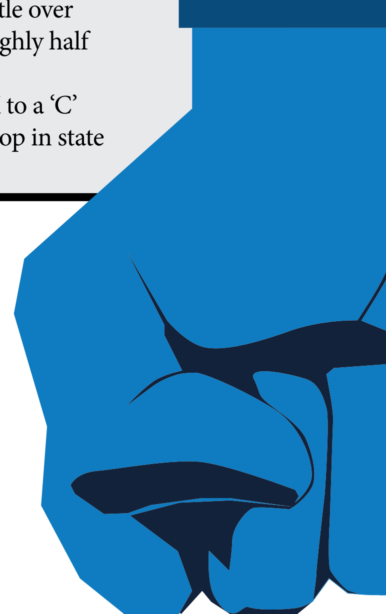


Summary

- The *Melbourne Mercer Global Pension Index* puts the UK as having the ninth best pension system in the world. This is ahead of the US, Germany and Japan, but behind Denmark and the Netherlands.
- The UK received a B grade with 65 out of 100, down from 67.6 in 2014. Pensions freedom was blamed for the drop, as it may pose long-term challenges to adequate retirement incomes.
- Low DC contributions is a concern of the UK system. The average UK employer contribution is 4 per cent, and the employee 2 per cent. In Australia, mandatory contribution is 12 per cent and in Sweden it is 18.5 per cent. However in New Zealand, the voluntary Kiwisaver has only just upped its contributions from 4 per cent to 6 per cent.
- Low engagement with pensions in the UK is another concern. This is attributed to the UK's individualistic culture, particularly with regards to savings and investments, in contrast to Denmark and the Netherlands, for example.
- The UK currently has about 6,500 DB schemes and 40,000 DC ones. In contrast, the Dutch have a little over 400 multi-industry schemes. Six million UK employees are now auto-enrolled into a scheme, with roughly half enrolled into master trusts, leading to expectations of scheme consolidation in the UK.
- The UK's almost entirely unfunded public sector and state pensions run the risk of relegating the UK to a 'C' grade in Mercer's index. However, pensions freedoms and the Lifetime ISA may counter a potential drop in state support for funding retirements.

The UK versus the world



In the race to build a pensions system fit for the modern world, how does the UK stack up against its global comparators?

If you take the annual *Melbourne Mercer Global Pension Index* as gospel, then the UK has the ninth best pension system in the world.

In its 2015 index report, the consultancy giant deemed the UK to be once again worthy of a respectable B grade; ahead of the likes of the US, Germany and Japan, but sitting well below angelic A-graders Denmark and the Netherlands.

Mercer judged the UK to have just managed to hold onto its B grade, with a score of 65 out of a possible 100, down from 67.6 in 2014. Pensions freedom was blamed for the drop, with the report arguing that it posed long-term challenges to adequate retirement incomes.

But that wasn't the only blot on its sheet. Sins such as the UK's low level of retirement saving, unfunded state pension promises, increasing old age dependency ratio and substantial government debt all threaten its ability to deliver pensions salvation.

Raising contributions

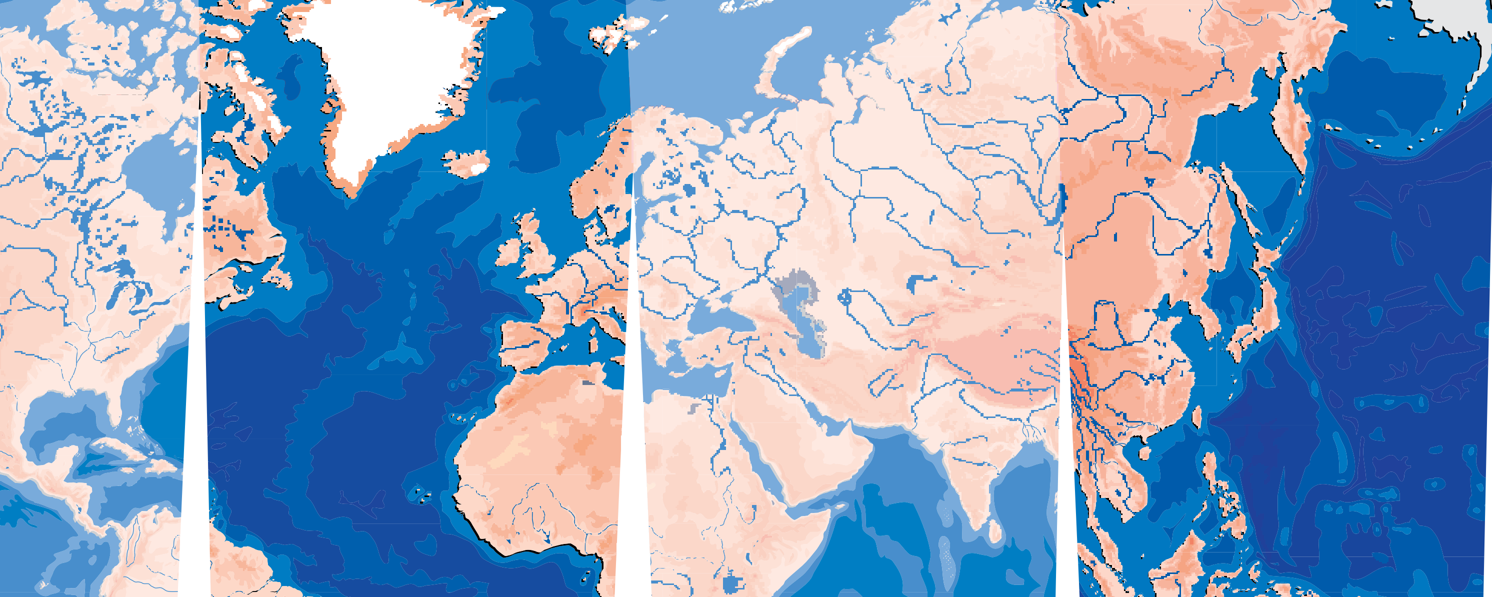
The first misdemeanour, low contributions into DC schemes, has long been a concern.

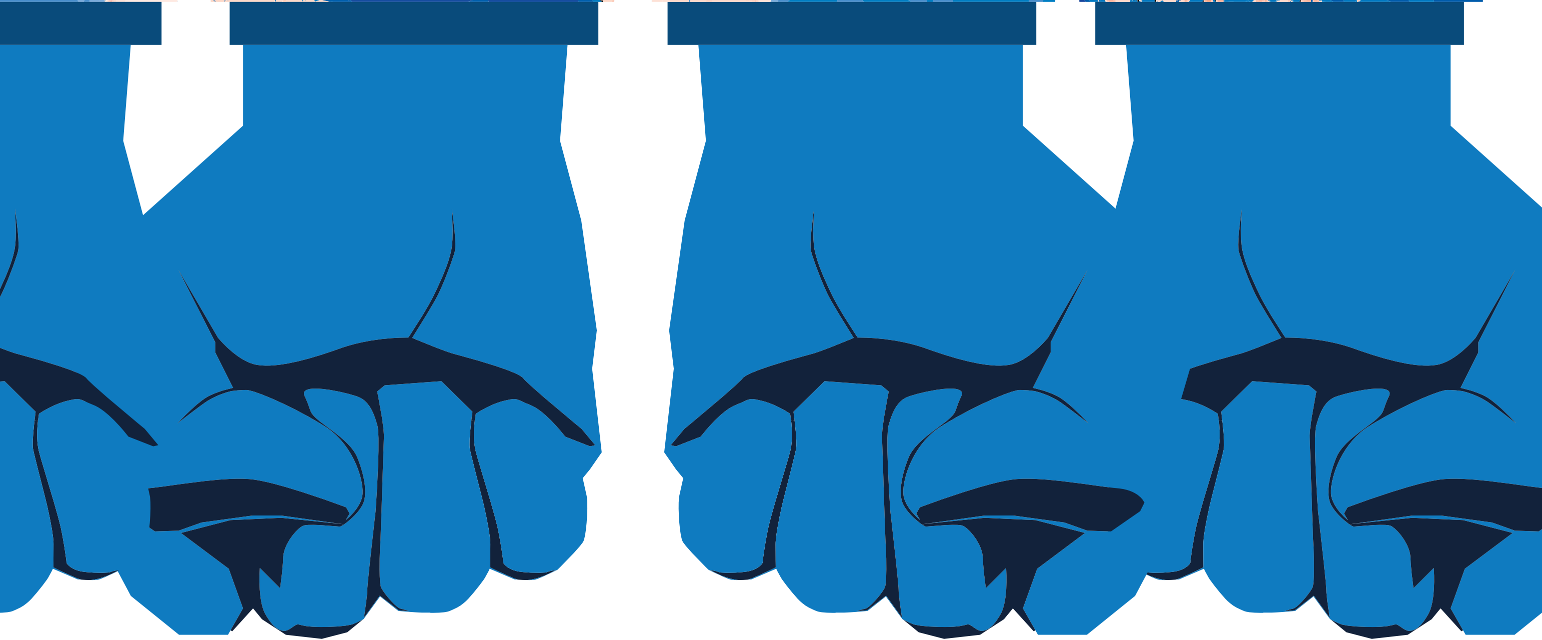
Columbia Threadneedle Investments head of pensions and investment education Chris Wagstaff says that for an average DC scheme in the UK, the employer contribution comes in at under 4 per cent, while the employee pays in a little below 2 per cent.

Research conducted by Columbia Threadneedle, in association with the Pensions Policy Institute, found that somebody on average earnings should be contributing between 11-14 per cent of their salary to ensure a good retirement income. This should be made from when they are aged 22 until the state pension age, presuming that they are eligible for a state pension that is index linked.

"When you look at our voluntary system, it falls quite a way behind mandatory and quasi-mandatory systems," says Wagstaff.

"So if you look at Australia, that mandatory contribution





is 12 per cent of earnings now, and if you look at quasi-mandatory systems, such as the Netherlands, the savings rates there are pretty good as well."

In Sweden, that amount is even higher, with an 18.5 per cent payroll deduction.

"What's interesting about the Swedish model is that it's deducted and invested for you," says BNY Mellon international head of pensions and insurance segments Paul Traynor. "Unlike the Japanese system, where they take a deduction for their defined benefit pay-as-you-go set up, a bit like how our national insurance contributions deliver our state pension."

Traynor says that he is concerned about workers in what he dubs the 'Uber economy', who cannot necessarily rely on paternalistic employers.

"The bad thing about auto-enrolment is that it allows people to contribute 2-3 per cent and then forget about it, thinking that they're contributing enough. No one is telling them that they're not," he says.

LCP partner Andrew Cheseldine says that although the UK has low contribution rates, it is not an outlier. The voluntary Kiwisaver in New Zealand, for example, has only just upped its contributions from 4 per cent to 6 per cent.

He also points out that the government's decision to raise the national living wage will boost DC contributions in the UK anyway, without any need for nudging or auto-escalation.

"The national living wage is going to increase DC contributions on average, across the board, by 40 per cent from 2020," he explains.

"It will go from £6.70 to £9.20 by 2020. So if my pay was £11,000 this year, then my pensionable pay was about £5,000. If I get a 40 per cent pay rise, then that takes me to £15,400 and my pensionable pay is now £10,000.

"So my pension pay will double."

Lower engagement

The UK's low contribution rates have also translated into low engagement, says Wagstaff.

"Part of the problem that we

have in this country is that we're very individualistic when we approach most things, not least with savings and investments," he says.

"When you look at Denmark and Holland, a lot of people do things that are of benefit to society, rather than themselves. They tend to have cultures where they do buy into the idea that they need to save for their future.

"That's something we lack in the UK."

To counter this, he says the UK could do well to replicate work that has been carried out in the US, which tries to tackle what they call 'present bias'.

American researchers have discovered that creating an avatar of a person aged 70, complete with spending habits, can help younger savers to identify with their future selves. It has also been shown to encourage people to double their contribution rates.

If adopted in the UK, this application of behavioural science could counter the danger of people pulling away from their pensions under contribution auto-escalation, which relies on apathy more than anything else.

Consolidation

On a macro level, imitating other countries' landscapes could also help to improve provision in the UK.

At present, the UK has about 6,500 DB schemes and 40,000 DC ones. The Dutch, in contrast, have a little over 400 multi-industry schemes.

Much has been made of the trend towards consolidation in both spheres, thanks to the emergence of master trusts. Wagstaff says that automatic enrolment has accelerated this.

Six million employees are now auto-enrolled into a scheme, with a little under 90 per cent having gone into DC arrangements. Out of that figure, roughly half have become members of master trusts.

"We reckon that over the next 10 to 15 years, that will be more like two thirds," he says.

"So in that respect, we are moving more towards a Dutch model, but we are quite a way away."

Traynor bemoans the continuation of the UK's fragmented landscape.

"The efficiencies I see in the Nordics, in the Netherlands, are wonderful. They allow for better outcomes for the DC members," he says.

These permit schemes to use scale to secure cheaper rates with investment managers, develop invaluable in-house expertise, and deliver first class communications to members.

New flexibilities

The Mercer report also warned that the UK was in danger of being relegated to the 'C league' as its public sector and state pensions are almost entirely unfunded and propped up by a government facing an increasing national debt and rising longevity.

In the case of the former, Cheseldine says it has caused a large degree of unfairness through the UK's system, which is not as acute in other countries.

"There are about six and half million active members of DB schemes: one million in the private sector and five million in the public sector, so there's a real mismatch compared to the public sector and everyone else."

The question marks over the state pension's sustainability are shared across the globe. Savers in some countries have used this knowledge to concentrate more on their private provision, as Traynor says.

"In the US, they are much more aware than we are that their social welfare system is not going to be the safety net that they should look to rely on," he explains.

"We still believe in this country that the state will be there for us. And the truth is that as time moves on, that is less and less likely.

"The state pension will become more unaffordable, and over 25 years will, in real terms, shrink."

Contrary to the fears expressed by Mercer, Traynor believes that pension freedoms and the creation of a Lifetime ISA in the UK will help to counter this drop in state support.

"I like what Osborne did to get rid of a compulsory annuity and what he did with Lifetime ISAs," he says.

Much like in New Zealand and the US, Osborne has begun to set up a pensions system where you can access funds before you retire.

"So there might be one or two lifetime events where you can access your savings and that will make saving much more appealing to a millennial," he says.

To back up his assertion, Traynor cites a global survey of attitudes to saving carried out by BNY Mellon and Cambridge University last year, which revealed that 63 per cent of millennials believed that they would save more if they could unlock their pension funds early.

With flexibility, higher saving rates and better nudging techniques, the UK may yet find itself a strong contender in the 'best pension system' competition.

Written by Marek Handzel, a freelance journalist