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New index attempts to evaluate the world's pension systems

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Pension schemes, a key component of income security systems to ensure an adequate standard of living for retirees, take various forms in different countries. Major societal differences among countries have made it difficult to comparatively evaluate pension schemes in different countries. A new global pension index, discussed below, was recently developed in Australia to compare pension systems internationally.

The difficulty of evaluating pension systems

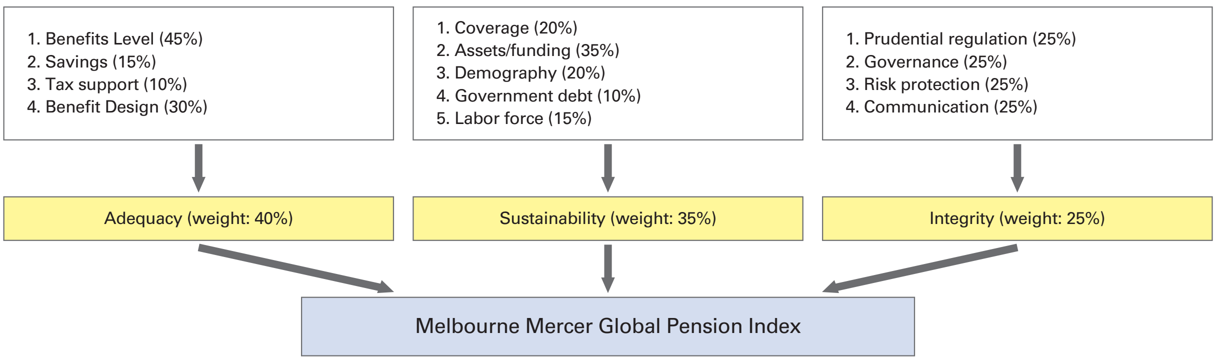
With many developed countries' populations progressively aging, developed countries face the common challenge of providing adequate healthcare and income security programs to enable retirees to live comfortably. Pension schemes are one such income security program. Because countries differ economically, socially, culturally, politically, and historically, pension systems vary between countries, making it difficult to directly compare their respective positives and negatives. For example, defined-contribution (DC) pension plans are not well regarded among Japanese defined-benefit (DB) pension experts because DC plans impose investment risk and longevity risk on their participants. In Australia, by contrast, DC plans are relatively popular, reflecting a social climate that prizes individuals' autonomy to make decisions for themselves.

A number of international institutions, including the OECD and World Bank, have previously attempted to compare pension systems internationally, but none has quantitatively evaluated pension systems. The absence of such quantitative assessments reflects the difficulty of quantifying pension systems. Below we discuss a recent attempt to overcome this difficulty by comparing pension systems through application of common assessment criteria to private and public pension schemes in different countries. The distinguishing characteristic of this approach is its use of comparison in the aim of identifying how to improve a country's pension system.

New pension index's characteristics

The Melbourne Mercer Global Pension Index, which measures global pension systems' effectiveness[1)], was unveiled in Melbourne, Australia, on October 14, 2009. The table below shows how the index is constructed. The index comprises three subindices, each of which encompasses several assessment criteria with different

Exhibit. Overview of Melbourne Mercer Global Pension Index



Source: NRI, based on Melbourne Mercer Global Pension Index (October 2009) weightings. Countries' pension systems are assigned a point score for each criterion. The country's index score is a weighted average of these point scores[2].

The three subindices respectively measure adequacy, sustainability, and integrity. The index evaluates pension systems from the standpoint of the level of income they provide (adequacy), their ability to continue to provide that income in perpetuity (sustainability), and their systemic reliability (integrity). Such a commonsense approach is highly cogent.

The adequacy subindex, which measures the magnitude of postretirement income, is the most heavily weighted of the three subindices. The evaluation criteria factored into the adequacy subindex include pension benefits' level relative to average preretirement compensation, the non-pension saving rate, whether contributions to retirement savings benefit from preferential tax treatment, and pension benefit entitlements' degree of portability when beneficiaries change employers.

Regardless of how generous the benefits it provides, a pension system that will become insolvent in the near future is of little value. True to its name, the sustainability subindex measures pension systems' long-term sustainability. An important factor in evaluating sustainability is how long-term risks are shared among stakeholders. If a pension system imposes a risk burden that exceeds any stakeholder's risk-bearing capacity, the system ultimately will not be able to survive for long. Measures of sustainability incorporated into the subindex include the level of mandatory contributions (as a percentage of wages) set aside to fund pension benefits, employers and employees' respective shares of pension contributions, and pension asset and government debt levels as a percentage of GDP.

The integrity subindex attempts to measure whether the private sector can support the pension system. With government finances severely strained in many countries, private-sector pensions are playing a growing role as a supplement to public pension programs. The integrity subindex measures how well private pension funds are managed in terms of prudential regulation, governance, risk protection, and communication. Specific evaluation criteria include stringency of prudential regulation by regulatory authorities, the required level of governance, whether minimum funding requirements exist, and whether pension finance reporting requirements exist.

Pension index's shortcomings

Although the Melbourne Mercer Global Pension Index incorporates generally reasonable evaluation criteria, it still has substantial room for improvement. For example, it should incorporate a measure of cost efficiency (costs relative to investment returns) and recognize the difference between rules-based and principles-based regulation of pension asset management (research has shown that this difference accounts for sizable differences in returns[3]). Another deficiency is that the index completely omits any measure of costs and investment returns on pension assets.

The Melbourne Mercer Global Pension Index's developers tested the index by using it to rate 11 countries' pension systems[4]. Japan ranked in last place among the 11 countries. The test was conducted using OECD data, but OECD data on Japan's pension system is widely recognized by experts as lacking accuracy. We checked several of the index's metrics and found some of the data to be questionable[5]. If such country rankings are to be publicly published, a greater degree of diligence is needed in terms of data accuracy.

Discussions of pension schemes' positives and negatives tend to degenerate into technical discussions of risk sharing (i.e., whether DB or DC schemes are better). The Melbourne Mercer Global Pension Index is the first attempt to improve pension systems' robustness as one pillar of postretirement income security. The index is significant in that it raises the issue of how to design pension schemes in accord with their intended purpose. Although the index has much room for improvement in terms of its content, it nonetheless should contribute constructively to improving pension systems.

Note

1) The index was jointly developed by the Melbourne Centre for Financial Studies and Mercer, a consultancy, with the support of the Victorian state government.

2) Details of the index's assessment methodology were published on Mercer's website, enabling interested parties to calculate scores for each assessment criteria using data from their own countries.

3) Under a rules-based regime, the authorities prescribe relatively detailed rules, which are applied on a case-by-case basis. Under a principles-based regime, the authorities prescribe a number of key principles and/or guidelines for regulated institutions to abide by and the regulated institutions operate in compliance with the principle/guidelines. Published research results indicate that returns are higher under a principles-based regime.

4) The 11 countries were Australia, Japan, Singapore, China, Canada, US, Chile, UK, Sweden, Netherlands, and Germany.

5) For example, the ratio of pension reserves to GDP was inaccurate, reflecting only a portion of the Employee Pension Insurance program's reserves.

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