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Pensions

ENHANCING PRIVATE PENSION SAVINGS

- Japan has been ageing rapidly due to improvements in life expectancy and low fertility rates. This challenges the financial sustainability, solvency and adequacy of the pension system.
- Contributing more and for longer periods is the best approach to face the challenges posed by population ageing to pension systems.
- Private pension savings are needed to complement mandatory public pensions. However, the design of pension plans needs to account for the fact that individuals exhibit behavioural biases and have limited financial knowledge, which may be exacerbated in an ageing society.

What's the issue?

Japan has been ageing rapidly due to improvements in life expectancy and low fertility rates. The fertility rate in Japan has fallen from the high levels following WWII and is currently at 1.4 children per women, well below the level that ensures population replacement at 2.1. Additionally, life expectancy has increased significantly, with Japanese women having the longest life expectancy among OECD countries. Consequently, Japan has the highest old-age dependency ratio in the OECD, with 46 individuals aged 65 and over for 100 persons of working age (20-64) in 2015, against 13 in 1975. The trend is expected to continue, with the old-age dependency ratio reaching 78 by 2050.

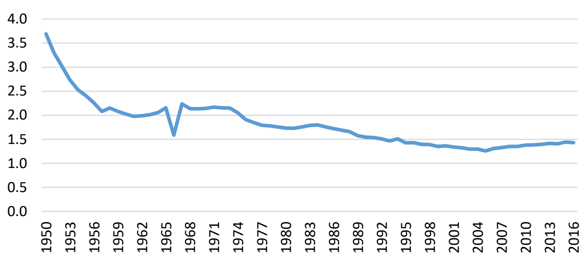
Savings in private pension arrangements are needed to complement mandatory public pay-as-you-go (PAYG) pension schemes and help people maintain their standard of living in retirement. The future net replacement rate from mandatory public schemes for a full-career average-wage worker is 40% in Japan, lower than the OECD average of 63%. People therefore need to save more, for example in private pension plans, to reach higher overall retirement incomes. In 2016, about half of the working-age population did not participate in any private pension plan in Japan.

Why is this important for Japan?

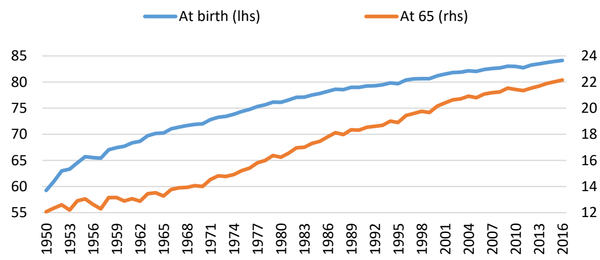
As a result of population ageing, as well as the current situation of low GDP and wage growth, and low returns and interest rates, PAYG pensions face financial sustainability problems, defined benefit funded pensions need to secure their continued solvency, and defined contribution pensions need to consider ways to ensure that individuals have an adequate income during

Population ageing in Japan results from a combination of low fertility rates and increasing life expectancy

The fertility rate in Japan has fallen and stabilizes at around 1.4



Significant increases in life expectancy at birth and at age 65



Source: Human Fertility and Human Mortality Databases.

retirement. Contributing more and for longer periods, especially by postponing retirement as life expectancy increases, is the best approach to face these challenges.

Pension funds and annuity providers are exposed to longevity risk owing to uncertainty about future improvements in mortality and life expectancy. The Japanese Minister of Health, Labor and Welfare, has pension funds updating mortality tables every 5 years, in line with the OECD recommendations. Moreover, it enables them to incorporate future improvements in mortality and life expectancy. The Japanese Financial Services Agency also requires insurance companies to utilize the mortality tables that the Institute of Actuaries of Japan updates regularly in light of increasing life expectancy. It would be interesting to assess those tables and the remaining longevity risk, following the international best practices and the approach contained in the OECD Monograph on Mortality Assumptions and Longevity Risk.

Increasing the role of funded private pension arrangements in retirement income provision implies the transfer of more responsibility to individuals for their retirement planning that they may have difficulty to assume. Planning for retirement indeed requires more financial knowledge and skills for people covered by funded private pension arrangements rather than public PAYG pension arrangements, as risks related to retirement saving (e.g. investment, longevity) are transferred to individuals. Unfortunately, behavioural biases and low levels of financial knowledge can undermine people's ability to take action and make appropriate decisions for their retirement at all stages of their lives. In an ageing society like Japan, this may represent an even bigger challenge. For example, procrastination, myopia and inertia can impede participation in retirement savings plans. In turn, loss aversion may affect savings levels, as contributions to retirement savings plans reduce take-home pay and people undervalue future gains in terms of retirement income. In addition, given the complexity of retirement products, individuals may lack the motivation to invest time and effort in making informed decisions. Therefore, they may be more likely to rely on simple rules of thumb and be sensitive to framing and persuasion. In this context, seniors face specific financial consumer protection challenges, such as access to financial products and services; the intersection of cognitive decline and more complex financial decisions; and elderly financial abuse and frauds. There is therefore a need to address the problems brought about by the conflict of interest facing those providing retirement products. Fintech and appropriate regulation may help.

What should policy makers do?

- Encourage people to contribute more and for longer periods to address the challenges that population ageing poses to pension systems.
- Assess the amount of longevity risk that pension funds and annuity providers are still exposed to, according to international best practices.
- Address the issues posed by behavioural biases and low levels of financial knowledge in retirement decisions by using automatic features (e.g. automatic enrolment in pension plans and automatic increases of contributions), default options (e.g. for the investment strategy, the post-retirement product), simple information and choice, financial incentives (i.e. tax incentives, matching contributions and subsidies) and financial education.
- Ensure that requirements around the suitability of financial advice take age-related factors into account to protect the elderly from the increased risk of fraud and misselling given the likelihood of reduced cognitive capacity at older ages.

Further reading

OECD Reviews of Pension Systems.
https://doi.org/10.1787/26164116

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https://doi.org/10.1787/pens_outlook-2018-en

OECD (2017), *Pensions at a Glance*.
https://dx.doi.org/10.1787/pension_glance-2017-en.

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