**Bridging Japan's Pension Savings and Returns Gap:**
**A Focus on Younger Generations**
***November 2020***

In May 2020, the Japanese National Diet passed pension system reform legislation broadening the eligibility of part-time workers – mainly women and the elderly – for the public pension system and raising the maximum age to start receiving benefits to 75 from the current 70. Issues surrounding the "super-aging" society are among the most pressing public policy priorities in Japan, and this latest legislative change is just one of many attempts to reform the country's pension system. Japanese retirees have long relied on the public pension system to fund their post-retirement living. In this super-aging society, however, sole reliance on the public pension system is not sustainable; a joint solution leveraging both the public and private pension systems will be essential to secure retirees' financial wellbeing.

## THE CHALLENGE

### 1. JAPAN'S PENSION SAVINGS GAP

As of 2018, over 28% of the Japanese population is aged 65 and over. This percentage is projected to further increase to 30% by 2025 and 39% by 2065[1]. Currently, about half of retirees rely on the public pension distribution as their sole source of income, even though the public pension only pays about 62% of pre-retirement income. By 2058, average households are projected to receive 20% less income from the public pension system[2,3].

The Japanese public is well aware of this retirement income challenge, but remains heavily reliant on the public pension system and has not made a significant shift to add private savings. According to a survey conducted by the Japan Association for Financial Planners, over three-fourths of respondents were "concerned for post-retirement life," with respondents in their thirties and forties being highly concerned (85% and 83%, respectively). While financial concerns were a major contributing factor to their responses, only around

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[1] "なぜ今、改革が必要なの?", Ministry of Health, Labour and Welfare, Government of Japan. https://www.mhlw.go.jp/stf/seisakunitsuite/bunya/hokabunya/shakaihoshou/kaikaku_1.html

[2] "2019(令和元)年財政検証結果のポイント", Ministry of Health, Labour and Welfare, Government of Japan. https://www.mhlw.go.jp/content/000540198.pdf

[3] "アニュアルレポート 2018", Japan Pension Service https://www.nenkin.go.jp/info/torikumi/annual/2018.files/2018-2.pdf

30% of the respondents chose “start accumulating assets early” as a solution to these concerns[4].

As the Japanese public pension system faces the challenges of a super-aging society—with a shrinking working-age population supporting the growing retiree population—the role of private retirement saving is and will be increasingly critical to help maintain retirees’ desired standard of living. Currently, individuals have two main tax-favored asset accumulation programs to choose from: namely, Nippon Individual Savings Account (“NISA”) and the individual-type defined contribution pension plan (“iDeCo”). Both of these programs are designed to encourage the general public to start asset accumulation with small monthly/annual contributions. The government has also promoted tax breaks and deregulation to reduce fees to encourage people to move savings into investment products. Yet the Japanese public opts to keep more than 53% of their financial assets in bank accounts over investment assets[5]. Only about 10% of the Japanese adult population hold NISA accounts and 1.6% of those eligible have iDeCo accounts, supporting the above survey results[6].

## 2. JAPAN’S INVESTMENT RETURNS GAP

In addition to the challenges discussed above, the Japanese public pension system should improve its investment rate of return to make the most of contributions from its shrinking base. The Government Pension Investment Fund (GPIF)’s rate of return is, in fact, one of the lowest in the OECD countries. While the GPIF has recently revised its portfolio guidance to increase foreign bonds to seek a higher return in the present low-interest environment, the allocation remains 50% bond and 50% equity with a very minimal amount invested in alternative assets (0.49% as of Q3 FY2019)[7]. Greater allocation to alternative assets would align the GPIF and other Japanese pension funds with secular shifts in financial markets. Private market assets under management (AUM) grew by 10% in 2019, and $4 trillion over the past decade, an increase of 170%. In comparison, over that same period, global public market AUM has roughly doubled[8]. Due to the declining birthrate and aging

[4] “世代別比較 くらしとお金に関する調査 2018”, Japan Association for Financial Planners. https://www.jafp.or.jp/about_jafp/katsudou/news/news_2018/files/newsrelease20181105.pdf

[5] “資金循環の日米欧比較”, Bank of Japan. https://www.boj.or.jp/statistics/sj/sjhiq.pdf

[6] “金融審議会 市場ワーキング・グループ報告”, Financial Services Agency, Government of Japan. https://www.fsa.go.jp/singi/singi_kinyu/tosin/20190603/01.pdf

[7] “Investment results for 3Q of fiscal 2019(update report)”, Government Pension Investment Fund, Government of Japan. https://www.gpif.go.jp/en/performance/2019-Q3-0207-En.pdf

[8] “McKinsey’s Private Markets Annual Review”, McKinsey & Company. https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/mckinseys-private-markets-annual-review#

baby boomers, by 2050, every elderly person aged 65 and over will be supported by 1.2 working age persons[9]. Considering the Japanese public pension employs a pay-as-you-go system, the system will not be sustainable without increasing investment returns.

## RECOMMENDATIONS

### 1. INCREASE CONTRIBUTIONS TO PRIVATE SAVING PROGRAMS

The Japanese government's recent pension reform legislation has helped set the future of the public pension system in the right direction by raising the retirement age and widening the base to include part-time workers and small business employees. More work needs to be done, however, especially to encourage younger generations to start saving early in their careers balancing between both public and private savings. The U.S.-Japan Business Council recommends that the Japanese government:

**a. Expand the base:**

The Japanese government should continue its efforts to expand public and private pension system participation by:

- Continuing to evaluate and raise the maximum age limits to begin payouts;
- Easing restrictions, including annual contribution caps, age limits, and periodic contribution requirements, on various private pension and investment programs, such as iDeCo and NISA;
- Providing the market with adequate tax-advantaged retirement solutions, including private supplemental protection against unforeseen illness and other negative shocks, such as dementia; and,
- Encouraging the public to holistically consider retirement planning, utilizing a combination of multiple pension programs and products to adequately address individuals' unique needs and circumstances. Individuals should balance various source of funds, including public pension, private retirement accounts, and investment accounts, all of which are complementary to achieve optimal financial sustenance in retirement.

Expanding the participation of the younger generation in private pension programs is of particular importance, considering the benefits of compounding investment returns, their ability to take more aggressive investment allocations for better returns, and the ongoing shift from traditional employment arrangements to a freelance economy.

[9] "OECD Pensions at a Glance 2019", OECD Library. https://www.oecd-ilibrary.org/finance-and-investment/oecd-pensions-at-a-glance_19991363

**b. Increase access:**

As the Japanese pension saving responsibility shifts from the government and businesses to individuals, the Japanese government should continue increasing access to retirement saving programs and prompt people to save by:

- Encouraging employers to sponsor defined contribution plans with automatic "opt-out" enrollment for employees. According to a study conducted in the U.S., 93% of eligible employees participate in retirement plans when the employer offers automatic enrollment as opposed to 47% with opt-in plans[10];
- Providing tax and other policy incentives for the retiree population to favor annuitized payouts over lump-sum distributions, where appropriate. The Japanese practice of lump-sum retirement allowance paid when employees retire provides an opportunity to convert such payments to long-term flows of income with the potential for asset growth and/or guarantee when appropriate financial instruments are utilized. The Japanese government should encourage and incentivize such conversions; and,
- Strengthening public-private joint efforts to share knowledge and develop a strategy to provide the public with adequate retirement solutions. This includes a review to determine whether the current tax-advantaged retirement saving programs sufficiently meet the needs of the public and to determine the pain points that currently prevent the public from participating in retirement plans.

**c. Promote communication and information dissemination:**

In order to raise awareness around possible fund shortages due to sole reliance on public pensions and to prompt people to begin saving for retirement, more holistic and strategic communication is necessary to penetrate the information among the public. Despite efforts by various industry groups and government agencies, the public knowledge and acceptance of various saving programs remains low. Further, the information should go beyond the mere introduction of individual saving programs. Rather, this communication should address holistic needs and solutions of individuals and discuss complementary combination of public pension system, private saving vehicles, and other private insurance products. This communication can be provided in:

- Seminars at higher educational institutions, new hire orientations, and annual pension days/weeks at workplaces to increase awareness and continue the messaging around the criticality of early retirement savings;
- Communication/seminars to educate those reaching the retirement phase on the need to create and extend their income stream, such as by using private financial instruments, including annuities, to turn a lump sum retirement allowance into monthly / annual income with growth and/or guarantee; and

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[10] "Automatic enrollment: The power of the default", Vanguard. https://institutional.vanguard.com/iam/pdf/CIRAE.pdf

- For employees of small businesses and non-traditional workers (i.e., gig-workers and contract workers), establish a creative mechanism to disseminate the information. These individuals are often more difficult to reach, but the need for the saving is the same, if not greater, and conscious efforts are critical.

**d. Strengthen capability:**
More robust and consistent financial literacy education empowers individuals to make sound financial decision-making with long-term perspective, and complements the communication strategy discussed above. Programs such as those created by the Central Council for Financial Services Information can serve as a foundation to build and strengthen the public's financial literacy. These educational programs should also be incorporated into school curricula and other continuing education opportunities.

## 2. INCREASE INVESTMENT RETURNS

Japanese policymakers and GPIF administrators should critically assess the future needs and sustainability of the fund. Specifically, the GPIF should continue to evaluate its portfolio guidelines and determine whether the current investment objective of a 1.7% real investment return is feasible to sustain its funds and provide a meaningful income source for the aging and expanding retiree population. Specifically, GPIF should consider increasing its allocation to alternative assets, for which the current maximum limit is 5%. In contrast, the Government of Singapore Investment Corporation and Korea Investment Corporation allocate 21% and 16% of their funds to alternative assets respectively. Increased allocation to alternative assets can materially improve returns performance. For example, data indicate private equity (PE) delivers ~480 basis points on average in excess returns compared to the MSCI World Index, with even stronger comparative performance during recessionary periods[11]. Selecting top performing funds can further magnify returns. Top quartile Asia-Pacific-focused PE funds, for instance, forecast a net internal rate of return (IRR) of 16% or higher, and PE outperformed public-market benchmarks by at least six percentage points across 1-, 5-, 10- and 20-year periods[12].

From the private sector's perspective, Japanese companies should improve their investability through more aggressive steps to improve corporate governance. This will not only improve management and board transparency and accountability, but will also lead to higher, more sustainable, and steadier returns. This will in turn attract new investors into the market and result in higher investment returns.

[11] "Private Investment Benchmarks", Cambridge Associates. https://www.cambridgeassociates.com/private-investment-benchmarks/
[12] "Asia-Pacific Private Equity Report 2020", Bain & Company. https://www.bain.com/insights/asia-pacific-private-equity-report-2020/

3. FOCUS ON STABILITY

Due to the relative novelty of early private retirement saving in Japan, private saving vehicles need to be stabilized in order to increase the public's acceptance and willingness to participate in these private saving plans. NISA and iDeCo were first introduced in 2014 and 2002 respectively, and as discussed earlier there is significant room to improve public awareness of these as an equally essential pillar of retirement savings on the same level as the public pension system. In particular, NISA is available on a limited time frame (5 to 20 years depending on the programs) and set to phase out. In order for these newer programs to gain public confidence and acceptance, the programs and their features, including associated tax incentives, should become permanent.

## CONCLUSION

In the "100-year life," people spend almost one-third of their lives in the post-retirement phase. The public and private sectors must work together to encourage individuals to be well-prepared for a secure and comfortable lifestyle after retiring. No single policy measure will close the current retirement savings gap. Rather, the public sector should establish a clear public policy on retirement preparedness and manage the public pension system sustainably. The private sector should also provide complementary saving vehicles and products. Both parties should coordinate their efforts to increase awareness so that individuals understand the need for early retirement planning without waiting until near retirement age to start taking action. This can be done using a combination of multiple programs based on individuals' unique needs and circumstances. All parties should act with a sense of urgency to solve this complex but critical societal issue.