VIEWPOINT

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Planning for Retirement –
Long-Term Savings and Investment in Japan

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Japan's average life expectancy at birth of 83.7 years[1] already is one of the highest in the world and growing fast. Thanks to advances in medical science, the time is rapidly approaching when people in Japan (and much of the rest of the developed world) will live to 100 years. At the same time, the healthcare, social security and welfare systems in place were built for a society where people lived to just 70 or 80.

Aware of the acute need to supplement the public pension systems with private defined contribution plans (DC) plans, Japan has introduced a number of reforms to encourage more widespread adoption of corporate and individual DC solutions. We believe there is much room for improvement in the Japanese DC system, as current coverage is limited, average balances are low, assets are predominately allocated to cash or capital guaranteed products, and there is a lack of appropriate decumulation solutions. In addition, the financial services industry has been slow to develop the tools and technology to help people navigate the retirement planning process.

With longevity increasing, now is the time to amplify the conversations that will lead to improved savings and investment behavior, more inclusive and higher functioning retirement systems, and stronger partnerships with the business community to support older workers. With this paper, we hope to share our perspective as the world's largest investor of global retirement assets on the challenges and opportunities — and submit for consideration a set of recommendations to frame the conversation and promote innovative solutions and improved retirement outcomes.

Current State and Structure of Pension System in Japan

Retirement and aging are among the most important issues the world faces — and nowhere are the challenges of longevity more acute than in Japan. With aging demographics and a very low birth rate (1.4 births per woman) Japan's population of 126 million is projected to fall by more than a third by 2065 and 60% over the next century[2]. The government hopes to keep population above 100 million, but this will be hard to achieve given the low birth rate. Since its peak above 87 million in the middle of 1990s, Japan's working-age population has shrunk by about 10 million. It is forecasted that it may even fall to 41 million by 2065, which would pose serious economic challenges[3].

The impact of longevity can be viewed via the dependency ratio[4], which measures the number of workers compared with the dependents they support. Japan's dependency ratio, which in 2015 was 64.5%, is predicted to reach 80.5% by 2037 and 94% by 2065[5]. The same ratio in the U.S., Germany and UK is much lower at 51%, 52% and 55% respectively[6]. Such a high dependency ratio along with dwindling birth rates suggests that fewer and fewer workers will be supporting retired workers drawing benefits. Japan's pay-as-you-go systems for universal pension and universal health insurance was introduced in 1961 when the dependency ratio was only 56% — a far cry from where it is today and where it is headed.

The opinions expressed are as of June 2018 and may change as subsequent conditions vary.

Recommendations to the Japanese authorities

Expansion of Defined Contribution (DC) Plans

1. Provide direct government subsidies or match government contributions to individual contributions to encourage more widespread adoption of individual DC accounts.
2. Impose a mandatory requirement on all corporate DC plans to offer auto-enrolment with an opt-out option.
3. Use tax incentives to promote the establishment of multiple employer plans amongst small businesses, or set up a public utility to provide scalable DC solutions for all employers however small.

Increase of contributions into DC Plans (corporate and individual)

1. Raise the maximum contribution limits for corporate and individual DC Plans.
2. Set contributions as a percentage of income instead of static limits.
3. Remove regulations that stipulate employee contributions cannot exceed those from employers in corporate DC plans.
4. Introduce mandatory auto-escalation in corporate DC plans.
5. Allow the withdrawal of DC assets in the form of a loan for specific needs before the age of 60.

Promotion of age-based asset allocation

1. Clearly define certain types of funds such as target date funds (TDFs) in the regulations as the appropriate default investment options.
2. Encourage the financial industry to consider the potential inclusion of alternative investments in DC plans.
3. Improve the inheritance tax treatment of mutual funds and listed stocks in line with other assets to encourage seniors to stay invested in the securities markets.
4. Collaborate with the financial industry to simplify investment asset allocation “pathways” for pre-retirees.

Introduction of suitable decumulation products

1. Change tax rules to encourage the selection of investment and insurance products instead of lump sum cash at the point of retirement.
2. Encourage the financial industry to work together to develop suitable decumulation products which may be a combination of annuities, systematic withdrawals plans (SWPs), home equity drawdown and cash payment.
3. Relax fund accounting constraints to facilitate the launch of systematic withdrawal plans with principal drawdown.

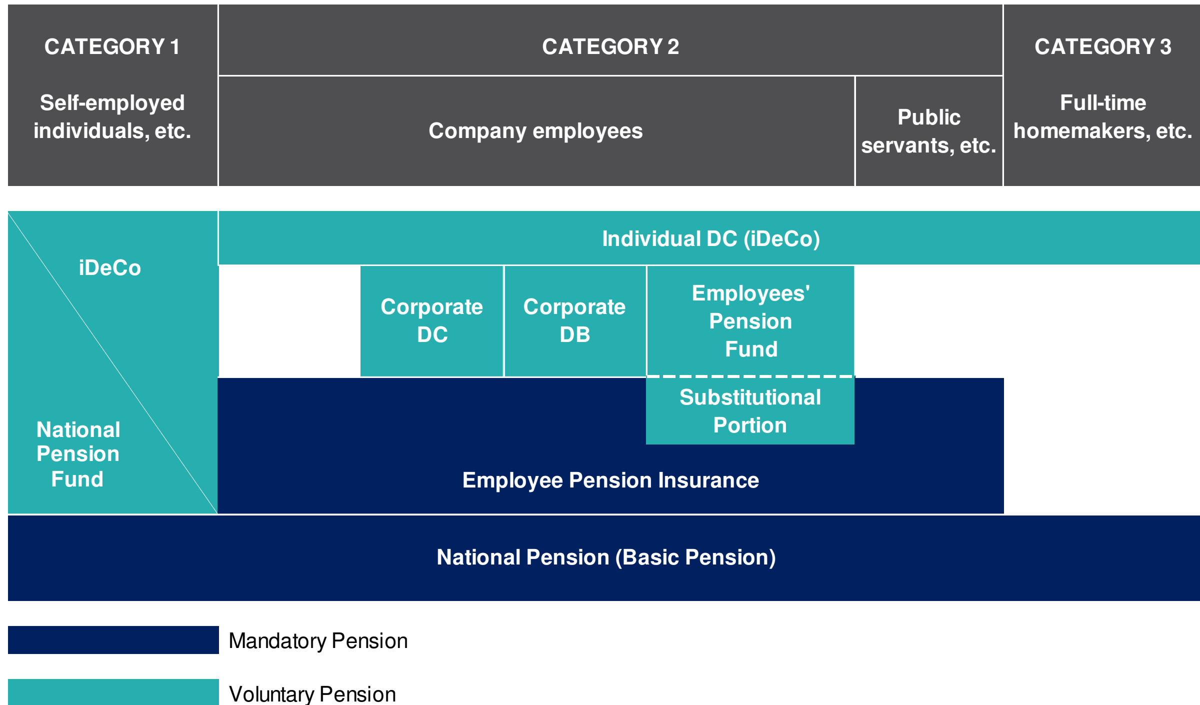
Increase availability of information, advice and tools for retirement planning

1. Require plan administrators to provide projected income at the point of retirement from plan assets to provide better information for retirement planning.
2. Encourage the financial industry to develop and offer better retirement planning tools leveraging technology and scalable processes.

Promote a business environment supportive of older employees

1. Explore policy incentives to encourage companies to expand on efforts offering flexi-time/part-time contracts to their senior employees.
2. Provide incentives to those companies who increase active participation of seniors in their workforce, ranging from tax benefits to preferential consideration in the government procurement process.

Exhibit 1: Overview of the Japanese Pension System



Source: Ministry of Health, Labor and Welfare (MHLW) and National Pension Fund Association)

Exhibit 1 illustrates the Japanese pension system as it stands today. The National Pension (Basic Pension) and Employee Pension Insurance are the public pension schemes. The Employees' Pension Fund (EPF), Corporate Defined Benefit (DB) Plans and Defined Contribution (DC) Plans as well as Individual DC Plans (commonly known as iDeCo) are voluntary pension schemes which supplement the public pension schemes.

When originally introduced, the public pension system was designed to offer retirees a modest but comfortable level of financial support. Today, with fewer workers and the working population aging rapidly, there are growing concerns about its sustainability. In response, the government has introduced a number of reforms to pension benefits, resulting in benefits being reduced and delayed:

- An automatic benefits adjustment mechanism was implemented in 2015 to restrain pension benefit increases below the rate of inflation and wage hikes. Beginning in 2019, cuts in pension benefits delayed during prior deflationary periods will be fully reinstated. In addition, starting in fiscal year 2021, pension payment adjustments will be based on changes in wages, regardless of inflation.
- The pensionable age is being gradually raised from 60 to 65 by 2025 for men and by 2030 for women. Discussions are currently underway to extend the pension age by another 5 years or more to 70 or older.

Japan's aging workforce has two prime issues to contend with at once: the existing public social security is inadequate to support them in retirement and as workplace retirement schemes shift to DC from DB, workers do not have the tools they need to undertake the responsibility they are being given.

The following sections comprise BlackRock's observations and recommendations around how increasing personal responsibility for retirement success needs to be supported throughout all phases of retirement planning. As we will discuss, an optimal DC system designed for 100-year lives will require:

- Adequate coverage and contribution rates during the accumulation phase.
- Greater access to age-based asset allocation solutions, such as target date funds (TDFs).
- Availability of suitable income products in the decumulation phase.
- Effective empowerment though a combination of simple guidance tools, expert advice and adoption of technology along the entire retirement savings life cycle.
- Increased government incentives to engender a more supportive environment for older workers and encourage the financial industry to innovate around solutions that support the 100-year lifespan.

Accumulation Phase

In order to support employees in their savings and investment efforts during the all-important accumulation phase, people need a robust private DC system — both corporate DC and individual DC plans. Coordinated government/corporate efforts will need to provide the incentives and solutions to help workers arrive at retirement with as much assets as possible. It is our view that the current DC system in Japan is improving but the following areas could be strengthened to increase participation rates and contribution amounts, such as auto-enrolment and auto-escalation, higher contribution limits and withdrawal flexibility.

DC plan coverage needs to be broadened

DC plans were introduced in Japan only in 2001[7] and have been growing slowly. As of December 2017, there are 5,678 corporate DC plans covering 29,132 employers with 6.4 million participants while membership numbers in individual DC (iDeCo) plans amount to only 780,000[8]. There is consensus that such coverage is grossly inadequate.

Against this background, the Diet passed the DC Amendment Bill in May 2016 implementing some of the most substantial changes to the DC pension market since its inception in 2001. The key changes are as follows:

- Scope of eligibility for individual DC plans was significantly expanded to include non-working spouses, public-sector employees and other groups previously only covered by DB pension plans.
- Simplified corporate DC plans for employers with fewer than 100 employees.

While the penetration rate of corporate DC plans is relatively high (over 40%) amongst large employers that have more than 1,000 employees, adoption is very low (<1%) for small employers with fewer than 100 employees. To accelerate the growth of corporate DC plans, the government could consider the use of tax incentives to encourage smaller businesses to set up multiple employer plans (MEPs). In a MEP, small companies can join together and create a pooled retirement plan, delegating certain onerous administrative and other responsibilities to a plan sponsor, creating economies of scale and lowering fees and expenses. In the UK, The National Employment Savings Trust (NEST) was set up as a public body accountable to the UK Parliament to act as a multi-employer pension provider. We recommend the Japanese government to explore the policy option of either providing tax incentives to promote the setup of MEPs or creating a public utility to provide scalable DC solutions for all employers however small.

Many but not all Japanese employer-sponsored DC plans automatically enrol employees into their plans. As the experience in the U.S. and UK has shown, auto-enrolment has been very successful in broadening coverage (see *Lessons from Behavioral Finance*). To firmly embed this practice amongst corporate DC plans, we recommend the Japanese government mandates that all corporate DC plans must offer auto-enrolment with an opt-out option.

Lessons from Behavioral Finance

At its core, behavioral economics (for which Richard Thaler recently was awarded the Nobel Prize for his work in this area) postulates humans make decisions and take actions at times based on what appears to be irrational behaviors. Understanding the tendencies or biases behind these unexpected actions can lead to insights and counter-measures to mitigate or forestall these actions. One observed bias is the preponderance of people to not change course or a “Status Quo Bias” when decisions are made for them. This led to the concept and application to retirement savings of “auto-defaults” where individuals are automatically defaulted into an investment savings plan and associated age-based investment portfolio. Individuals can choose to not participate or “opt-out” but the overwhelming results seen in the UK (which has an opt-out rate of 8%) and U.S. reinforce the very low opt-out rates behavioral economics expected. This “auto-default” pension design strategy is now being explored for the decumulation phase of the retirement savings lifecycle in Australia[9] and the UK[10]. The industry watches this development with keen interest for its applicability in Japan in the future.

Although the regulatory change to broaden eligibility for the setup of iDeCo has been enacted, the adoption rate is still slow. Japan can look to government initiatives in Germany and New Zealand which have been effective in raising coverage to the highest levels among voluntary pension arrangements[11]. In the case of New Zealand’s “KiwiSaver”, the government matches employee contributions up to NZ$10 per week and “kick-starts” each employee account with NZ$1,000. Germany has successfully used incentives to encourage uptake of Riester pension products on a large scale, including tax deduction for a 4% minimum contribution by participants plus annual government subsidies of €175 for single persons, increasing to €308 for married couples and €185 for every child and €300 if born after 2008. (The design of the Riester products has however been the subject of much debate, particularly as the “new normal” low interest rate environment has challenged returns.) Such policy initiatives as the provision of tax credits, injection of direct government subsidies into individual DC accounts and the matching of government contributions to individual contributions up to a certain amount should be considered. For ease of understanding by the general public, we recommend expressing the value of government contribution in monetary terms instead of percentages.

Contribution rates need to be increased

Despite having been increased three times since their inception in 2001, the contribution limits of DC plans in Japan are still low relative to global benchmarks. For example, for corporate DC plans the contribution limit depends on whether there is the existence of a DB pension plan from the employer. The maximum annual contribution from both employer and employee is ¥660,000 (about US$6,000) if there is no DB plan and ¥330,000 (about US$3,000) if a DB plan exists. The contributions limits for iDeCo are also set at relatively low levels as shown in Exhibit 2.

This contrasts with other countries such as the U.S. and UK. U.S. contribution limits for employees in 2018 are US$18,500 with an additional "catch-up" contribution of US$6,000 for people 50 or older. Total DC contributions, including employer and employee contributions, are limited to US$55,000 per year. In the UK, the total annual tax-exempt amount that can be contributed to a DC pension is £40,000 (less contributions to a DB plan).

With so many workers fast approaching retirement age, there is an urgency to accelerate wealth accumulation in Japan's DC plans as the total asset size of approximately ¥10 trillion or US$90 billion is relatively small. We recommend the government increase the maximum contribution limits to similar levels as in U.S. and UK to improve Japan's replacement ratio — which as of 2016 was 57.7%[12], lower than the OECD average of 58.7% and significantly behind those for other countries such as Netherlands (96.9%), Canada (75.2%) and the Unites States (71.3%)[13]. Increasing the DC contribution limits will also result in more equitable treatment of DC plans compared to DB plans which are not subject to contribution limits.

Japanese corporate DC plan participants accumulate assets mainly from employer contributions. This contrasts with the U.S. where a considerable portion of 401K plan assets comes from employee contributions. In addition, Japanese regulations stipulate that employee contributions cannot exceed those from employers. This effectively anchors employee contribution rates to the whim of their employers and restricts their ability to save more even if they wish to. We believe this restriction should be relaxed in order to give plan participants the freedom to contribute higher amounts. By providing participants more control, this will also encourage more engagement, connection and sense of ownership between employees and their retirement assets.

Exhibit 2: Maximum contribution by type of plan holder (Thousand yen)

CATEGORY 1	CATEGORY 2					CATEGORY 3
Self-employed individuals, etc.	Company employees				Public servants, etc.	Full-time homemakers, etc.
iDeCo (816)[b] / National Pension Fund	iDeco (276)	iDeco (240)[c]	iDeco (144)[d]	iDeco (144)	iDeco (144)	iDeco (276)
		Corporate DC (660)	Corporate DC (330)	Corporate DB (Unlimited)		
			Corporate DB (Unlimited)			
	Employee Pension Insurance (Depends on income)					
National Pension (Basic Pension) (Approx. 196)[a]						

Mandatory Pension

Voluntary Pension

Source: MHLW and National Pension Fund Association

a. For the year 2018.
b. Maximum total of iDeCo contributions and National Pension Fund contributions.
c. Provided that the maximum contribution to a Corporate DC Plan is set at ¥420,000.
d. Provided that the maximum contribution to a Corporate DC Plan is set at ¥186,000.

Instead of just setting contributions based on a static limit, we believe contribution rates should be closely linked to income levels. For example, a contribution of 6% or 9% of salary may align closer to their standard of living. A "percentage" approach could help create a connection between employee and employer contributions and will also be in line with general practices across the world. Although the recommendation of a specific contribution rate is beyond the scope of this paper, we would ask the government to undertake a holistic study of various factors to determine the optimal rate. Inputs would include the target income replacement ratio, the existing coverage of public pension systems, pay-outs from corporate DB plans, accumulated balances in DC plans and the average number of years away from retirement.

Another desirable feature to introduce into the corporate DC system is mandatory auto-escalation, which accelerates contributions as income level rises with promotions and longer years of service. In the U.S., adoption of such auto features are on the rise. Nearly 80% of firms that have auto-enrolment also offer auto-escalation for their DC plan participants[14]. Such a feature is credited with increasing participation and contribution rates wherever it is implemented.

Restrictions on early withdrawals can be relaxed

A potential disincentive for people in Japan to contribute more to their DC plans is the inability to withdraw DC assets for any reason before the age of 60. Early withdrawal of DC assets before retirement age is considered contrary to the principle of pension savings and hence is strictly prohibited. Due to this loss of liquidity of assets placed in DC plans, people are reluctant to contribute more of their savings into retirement plans for fear that they will not have access to these funds in the event of emergencies.

We believe there is merit in allowing early withdrawals in the form of a loan under specific circumstances, such as large out-of-pocket medical expense, and when certain conditions are fulfilled, such as when DC plan balances exceed a certain threshold[15]. In the U.S., it is permissible for a person to borrow up to 50% from their vested DC plan balance up to a maximum of $50,000 but requires repayment back to the person's plan within five years, including interest. Such an allowance may mitigate a potential fear some employees have preventing them to save more while helping ensure that the plan participant replaces borrowed assets.

Age-Based Asset Allocation

For most employees, savings alone will not get their assets to a sufficient level to fund a 100-year life. Their assets will need to be invested, and the potential for compounded returns over a decades-long investment horizon will be an important factor for reaching accumulation goals. While an investing culture in Japan is not as strong as it is in many developed countries, sitting in cash or other conservative investments is no longer an option. The general preference in Japan for cash over long-term investment products is driven in part by the Japanese stock market's past performance but also by the lack of financial knowledge and suitable advice. One of the reasons age-based funds have become so popular in other markets is their relative simplicity from a participant's perspective while offering asset allocation, risk management and rebalancing under the hood. Japan could also see more widespread target date funds (TDF) adoption — and increased investing in general — if the right incentives were offered.

Asset Allocation needs to tilt away from cash to age-based investing

Asset allocation plays a crucial role in driving the ultimate value of DC plan savings at the point of retirement. It is therefore very important for people to manage their funds effectively towards capital appreciation over the long term. However, if we look at the DC system in Japan today, we find that asset allocations do not reflect long-term investment horizons, with more than 50% of assets held in bank deposits and insurance products which carry a principal guarantee. Even people in their 20s, 30s, and 40s — with retirement far into the future — tend to be very conservative. This raises the question of whether they are going to be able to accumulate enough assets to enjoy the type of retirement lifestyle they hope for. Cash and principal guaranteed products do not offer protection against inflation over the long-term. TDFs are preferred over cash as they provide portfolio diversification, they are designed for long-term capital appreciation and they offer retirement plan participants who are not financially sophisticated a simple solution to meet their investment objectives as they change over time.

In Japan's DC industry, default options do exist but have traditionally been earmarked for contributions that are temporary or exceptional[16], and bank deposits or insurance products have been set as default investment options in many cases. The government is aware of this challenge and hence in the 2016 DC Amendment Bill introduced the following two changes:

1. A set of criteria for default funds are stipulated by law with the aim of preserving capital under various economic conditions from a longer-term time horizon, as opposed to those currently positioned as a temporary repository of savings.
2. Both corporate and individual DC plans are subject to a maximum of 35 investment options. A series of TDFs count as one option.

Under this amendment, diversified multi-asset strategies such as TDFs are considered suitable for this purpose but the regulations stop short of clearly designating them as the default option. In June 2017, an expert panel within the Social Security Council concluded that any type of fund that included a principal protection would be eligible as a default investment option. This has had the effect of preserving the current asset allocation status quo of principal protection products, which we believe is contrary to the original intention of the regulatory amendment and a missed opportunity.

Although TDFs are gaining more awareness and acceptance both as a default fund and core DC investment option in Japan, there is still room for improvement. We are of the view that TDFs should be clearly defined in the regulations as the appropriate default investment options in lieu of principle protection products. For example, under the Pension Protection Act of 2006 in the U.S., the Department of Labor (DoL) set clear rules where TDFs, balanced funds and managed accounts are defined as Qualified Default Investment Alternatives (QDIAs). Today, nearly 93% of U.S. plan sponsors offer TDFs as their QDIA[17]. Academic studies in Europe based on historical data[18] have also affirmed the advantages of life-cycle investment solution in terms of risk mitigation and performance enhancement.

At the same time, the industry should also re-examine the design of TDFs offered in Japan to determine if they are optimising all sources of investment returns and if they are sufficiently leveraging the long-term investment horizons inherent in retirement investing. We pose the view that alternative investments may have a role as a building block within TDFs, as they can complement traditional asset classes by providing diversified sources of returns.

Inheritance tax deductibility of publicly traded securities needs to be improved

It is important that we remove roadblocks for people investing assets for long-term growth. The inheritance tax treatment of mutual funds and listed stocks significantly detracts from their appeal as an investment vehicle when individuals consider intergenerational transfers. Under Japan's inheritance tax law, publicly traded securities including mutual funds are valued at fair value at the point of death of the decedent and do not carry any tax deductibility benefit. As the chart in Exhibit 3 illustrates, other assets are valued at substantially less than fair price due to difficulties in assessing the fair value of illiquid assets and the intention to protect tax payers from price fluctuation.

The Financial Services Agency (FSA) has been requesting the Ministry of Finance to introduce a reduction program on inheritance tax for publicly traded securities and mutual funds in order to protect taxpayers from price fluctuations. The request is for a 10% reduction in valuation, and exceptional valuations for securities that have had a sudden drop in price[19].

Exhibit 3: Japanese Inheritance Tax Treatment of Various Asset Classes

	Inherited Asset	Reduction program on inheritance tax
Has risk of price fluctuation	Land	Valued at approx. 80% less than the official land price for the property where the decedent lived, 20% less for other land
	Buildings	Valued at 30-50% less than initial investment
	Membership of golf club	Valued at 30% less than traded value
	Publicly traded securities and mutual funds	**No reduction**
No risk of price fluctuation	Life insurance	¥5 million reduction of value per legal heir (e.g. ¥20 million deduction if 4 legal heirs are existent)
	Cash, deposit	No reduction

Source: Financial Service Agency (FSA), Ministry of Finance

If the reduction is granted, it would have the beneficial impact of:

- Incentivizing senior households to stay invested in securities and mutual funds, resulting in more diversified portfolios than ones tilted towards illiquid assets such as property and life insurance products.
- Improving investors' ability to counter longevity and inflation risk through long-term market appreciation.
- Familiarizing more families to hold securities and mutual funds through the intergenerational transfer process.

Investment asset allocation for pre-retirees needs to be simplified

The 10 years before retirement is a particularly critical period to ensure retirement readiness. This is the stage when the plan participant's ability to contribute is often the highest, the cumulative balances in their DC plans are the largest and the impact of asset allocation on the value of savings at retirement is the greatest. Depending on one's objectives for retirement, the level of risk tolerance and retirement spending needs, pre-retirees may want to consider different investment asset allocations during this period in order to ensure a smooth transition into retirement.

The UK offers an interesting approach to help pre-retirees select an asset allocation or "pathway" in pre-retirement that bridges the investment strategy during this period to the investors' retirement objectives. The UK pension community has designated three "pathways" which are very similar to target date fund glidepaths. The first pathway has an asset allocation during this 10-year period that anticipates the investor will purchase an annuity at the end of the period or as one enters retirement. The asset allocation will progressively become more conservative replacing equity exposure with fixed income. A second pathway assumes the investor will stay invested into retirement and retain equity exposure of up to 40% of the portfolio at retirement. The last pathway is for investors looking to receive a cash lump sum at retirement. This portfolio will ramp down equity exposure replacing it with a cash allocation at retirement. This 3-pathways approach has become popular in the UK with a growing proportion of investors remaining fully invested into retirement. We believe there are benefits for the Japanese asset management industry to adopt this approach to help simplify the choice of "pathways" for pre-retirees.

Decumulation Phase

Decumulating assets during retirement comes with a new set of challenges, because no one knows for sure how long retirement will last. Retirees need guidance for how they can best manage their assets for needed income while not putting themselves in danger of outliving their assets. For most, assets will need to stay invested in order to fund what could be 20, 30, or even 40 year retirements. Tax rules encouraging people to cash out investments at retirement as well as accounting rules that discourage retirees from deploying systematic withdrawal plans on their invested assets should be re-examined.

Preference for lump-sum cash payment needs to transition to longer-term investment products

The retiring population in the coming years is expected to live longer and healthier lives but in an environment characterized by lower investment returns and interest rates. This will put many in a situation where their accumulated wealth needs to support a retirement life that is longer than initially planned. It is therefore more sensible to stay invested throughout retirement and extend the life of their nest eggs. However many retirees prefer to take a lump-sum payment at retirement and keep it in bank deposits hoping to live on the interest income and simply not spend the principal for fear of outliving assets. Recent U.S. research published by the BlackRock Retirement Institute[20] confirms this type of "husbanding of assets" behavior in retirees.

In Japan, 72% of DB and 94% of DC plan participants elect to cash out their accumulated wealth at retirement due to the favorable tax treatment of lump sum withdrawals[21]. If the pension receiver elects to receive pension in a lump-sum, he/she is able to receive tax exemptions based on the years of service in that company. For example if the person has worked 38 years in a company from 22 to 60 years old, he/she will receive total ¥20.6 million in tax exemption, and will only be taxed on half of the amount after exemption[22]. If the receiver elects to receive annual pension payments, he/she will be taxed based on the full value of the payment.

Retirees taking lump sum payments tend to keep them in cash as a result of behavioral biases and inadequate investment guidance. Such an approach will deliver highly sub-optimal results for many retirees whose primary goal is to maintain a consistent standard of living throughout retirement. This is because the tax savings that lump sum pay-outs offer in the short-term will be offset by losses to inflation and foregone market gains in the long-term. We recommend the government revises the tax system to equalize the incentives between taking a lump sum retirement payment and remaining in the capital markets to leverage a long investment horizon.

In many DC schemes around the world, retirees have the option to continue investing while withdrawing assets. With a relatively small DC investor base in Japan, funds available on the platform naturally focus on the pre-retirement asset building phase. As an example, most TDFs in the market are managed to retirement and they will either terminate or keep asset in cash or cash equivalent thereafter. In other words, the fund providers assume most DC assets will be withdrawn at retirement.

We believe changes in the tax system discussed above will encourage service providers to expand their product and service offerings and provide more investment options for retirees. The industry should also design a new generation of TDFs that do not expire at the point of retirement but have a longer investment horizon to help retirees stay invested during the decumulation phase.

The offering of decumulation solutions needs to improve

Retirees need regular income products that can provide stable cash flow. In Japan, monthly distribution products emerged around 2001 and gained huge popularity.

These monthly distribution funds started as income solutions but eventually devolved into dividend payment competition between products. Such "double-decker" products, which generally invest in high yielding assets and overlay them

with complex structures (most often currency exposures) to earn extra theoretical yields, are not appropriately designed for decumulation as their over-riding objective of yield often leads them to take excessive risk and complexity not well understood by investors.

The decumulation product market is still in a nascent stage across the world and Japan is no exception. We believe retirees should maintain a well-diversified portfolio engineered to maximize the value of retirement savings over a lifetime while providing payout stream diversity. The optimal solution may be a combination of the following:

- Annuities
- Lump-sum cash payment
- Systematic withdraw programs (SWP)
- Home equity drawdown (or reverse mortgages)

We discuss the benefits and disadvantages of each below:

Decumulation Strategies	Pros	Cons
Annuities	• Only means to guarantee lifetime income and investment return • Favorable tax treatment in Japan • Pooling of mortality credits is the most efficient means to protect against longevity risk • Can be purchased in advance, e.g., secured during pre-retirement phase • Inheritance objective available through death benefit • Established markets globally offer multiple examples / solutions / features to facilitate client customization, e.g. deferred annuities	• Lose control and flexibility to manage assets • Usually difficult (and expensive) to unwind once annuitization has started, i.e., high surrender fees and a general lack of secondary market • Products can be complex and difficult to explain exposing individuals to unmet or unexpected outcomes • People have difficulty assessing the value associated with longevity risk • Fees can be expensive and opaque compared to investment products • Benefits may be limited depending on life expectancy
Lump-sum cash payment	• Maximize control of assets and ability to use as one wishes • Maximize liquidity of assets • Efficient approach to pay off immediate liabilities • Aligns with preference to hold significant cash allocations	• No ability to manage longevity risk • Can lead to sub-optimal use of assets, i.e., spend them too fast or not enough • Impulsive purchases become easier to execute • Require significant planning and self-control expertise to efficiently manage risks and assets, which will be problematic for people facing cognitive decline in later life • More susceptible to fraud / abuse especially for seniors
Systematic withdrawal programs (SWP)	• Provide guidance to effectively manage asset draw down and optimize assets • Provide flexibility to deviate from plan distributions for unforeseen expenses • Age and risk-based asset allocation will best balance short and long term needs and risks • Give retiree a long range estimate on distributions so can plan spending accordingly • Can incorporate bequest objective into withdrawal strategy	• Do not provide any guarantee, i.e., still exposed to sequence of returns, market and longevity risks • Depending on methodology it may not be sufficiently customized • Depending on level of market exposure downside risk could force spending reduction • Diversity of methodologies may lead to very different outcomes and customer confusion • Will require changes to accounting rules in Japan to launch SWP in the form of funds (see *Japanese Fund Accounting Constraints*)
Home equity drawdown / reverse mortgages	• Usually significant untapped asset source for all wealth groups • Debt not transferred to the next generation • Able to remain in one's own home	• Retirees uncomfortable with downsizing or the loss of ability to transfer housing to the next generation • Undeveloped, illiquid markets • History of questionable practices and operators in some countries, but can also work well in markets where governments have stepped in or where responsible product designs and sales process have restored confidence

Japanese fund-specific accounting constraints

Under Article 55 of the Rules for Valuation and Accounting of Trust Assets, open-end investment trusts can in principle make distribution only from income gains and capital gains (subject to a condition that when a capital loss is booked in the latest fiscal period, these gains are not distributable). Capital is not considered distributable under the current rules.

When a fund tries to pay out distributions that may consist of capital, the most conventional approach to avoid a breach of the rules is to put in place a two-layer structure. A local fund is set up to invest into an offshore vehicle that does not need to operate within the distribution constraints. The offshore fund makes distributions regardless of their sources and these distributions are recognized by the local fund as "dividend income" which qualifies as distributable asset.

The additional offshore vehicle in the structure does not come free and the cost is not negligible.

To facilitate the launch of funds that support systematic withdrawal in Japan, exemptions from the accounting constraints should be granted if:

- the fund explicitly states decumulation of principal as part of its objectives, and
- the underlying strategy is suitable for long-term investing.

The authorities can consider an approval system that is similar to that for Installment NISA where the FSA reviews the products and provides approvals on application from the investment managers. A new version of NISA based on SWP funds can then be launched targeting retirees in decumulation phase.

Availability of information, advice and tools

A BlackRock survey[23] indicates that only 30% of people in Japan understand how much they need to save for retirement. It is well recognized that retirement planning should begin early in one's working life but most people do not have the skills to self-manage this process. While national education programs could be a solution, standard adult financial education programs are not in general very effective. The default, nudging/behavioral finance approach (such as auto-enrolment, auto-escalation, and default age-based investing) is far more successful as is practical guidance and advice.

Any decision-making process benefits from good information such as understanding retirement spending needs and projected retirement income. Since 2013, the U.S. Department of Labor (DoL) has been considering a requirement that DC plan participant statements provide a projection of retirement income based on a participant's assets. Though the rule has not been issued, the policy intention is clear that such information would serve to provide better transparency around future retirement income. We recommend that the Japanese government require plan providers to include this type of information into a participant's DC statement to enhance clarity around projected retirement income.

Participants would also benefit from having access to easy-to-understand planning tools that can help navigate the very complex decision-making process of retirement planning. The complexity arises from the large number of variables, such as cost of living in retirement, the projected retirement income and the individual's risk tolerance. The cost of living in retirement in turn depends on factors such as family structure, residential needs, and retirement lifestyle while projected income depends on the expected savings at retirement, the savings portfolio's asset allocation and long-term capital markets returns assumptions. User-friendly tools that put complicated calculations under the hood and distil the input variables to only a few key factors would be very helpful. Technology that employs data visualization and enables instantaneous customization can greatly enrich the retirement planning dialog between financial advisors and their clients. We believe the financial industry should play an active role in developing such guidance tools to steer people in their retirement planning.

Promoting engagement and health of the senior population

Any proper retirement plan should make health, both physical and mental, a priority as well. Hence the key question is how to maintain the health and engagement of seniors, and one avenue is through extended employment. We have already seen the Japanese government extending the retirement age by 5 years and current discussions are underway to extend that by another 5 years to 70 or older. To take a step further, the government can explore policy incentives to encourage companies to offer flexi-time/part-time contracts to their senior employees irrespective of their age.

Encouraging more seniors to stay employed has multiple benefits including more earnings for the individual, higher consumption from enhanced financial security, deferred payment of pensions for the government, and increase in labor participation rates for the economy. There is also evidence of positive correlation between engagement and well-being, with well-being defined in the broader sense of nutrition, mindfulness, security and self-expression leading

to better health. When the older population is healthier, it can help to contain the growth in healthcare cost.

We believe the government can play a catalytic role in creating a business environment where companies across all industries are encouraged to increase or promote active participation of seniors in their workforce. For instance, the government could provide "pro-retirement" companies with certain incentives, ranging from tax benefits to evaluation bonus points in the government procurement process.

Companies today are well advised to understand the societal impact of their business as well as the ways that broad, structural trends — including aging demographics — affect their potential for growth. As BlackRock Chief Executive Larry Fink said in a letter to the CEOs[24], "To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate." Businesses will find that besides positive societal contribution promoting senior employment can also raise productivity, increase loyalty and diversity in perspectives, thereby improving financial performance. We therefore believe it is in the interests of both the private sector and the government to collaborate on this initiative and change the perception of senior people from being a cost or burden on the economy to active economic contributors. In order to help achieve this goal, Japan might need a classification system whereby companies promoting senior workforce participation can be properly identified and rewarded.

Conclusion: Shaping positive futures built to last

All eyes are on Japan as it leads the world in adjusting to the "100-year life". As workers realize their retirements will be nearly as long as their working years, to continue to thrive will require a national commitment — personal, business and government. To quote Prime Minister Shinzo Abe, "I have absolutely no worries about Japan's demography. Japan is aging. Japan may be losing its population. But these are incentives to us."[25]

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