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Financial Preparedness for Old Age

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Introduction- Public policy goal should be ageing with dignity. It implies that a person should be ageing-in-place, staying at home to the maximum number of years as possible, and have access to a bundle of services, especially affordable and accessible health care.

According to UN projections, the number of persons over-60 years of age will increase from 205 million in 1950 to 2.1 billion by 2050.

"Given the deficiencies of storing current production, the *only* way forward is through claims on future production. What matters, therefore, is the level of output after I have retired. The point is central: pensioners are not interested in money (i.e. colored bits of paper with portraits of national heroes on them) but in consumption – food, heating, medical services, seats at concerts, etc. Money is irrelevant unless the production is there for pensioners to buy."

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Financial Preparedness for Old Age

Mukul Asher

I. Introduction

Public policy goal should be ageing with dignity. It implies that a person should be ageing-in-place, staying at home to the maximum number of years as possible, and have access to a bundle of services, especially affordable and accessible health care.

According to UN projections, the number of persons over-60 years of age will increase from 205 million in 1950 to 2.1 billion by 2050.

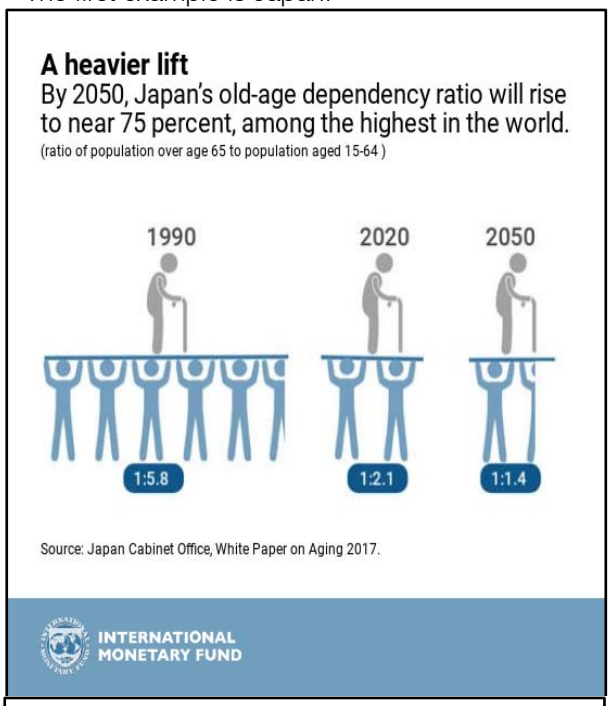
"Given the deficiencies of storing current production, the *only* way forward is through claims on future production. What matters, therefore, is the level of output after I have retired. The point is central: pensioners are not interested in money (i.e. colored bits of paper with portraits of national heroes on them) but in consumption – food, heating, medical services, seats at concerts, etc. Money is irrelevant unless the production is there for pensioners to buy."

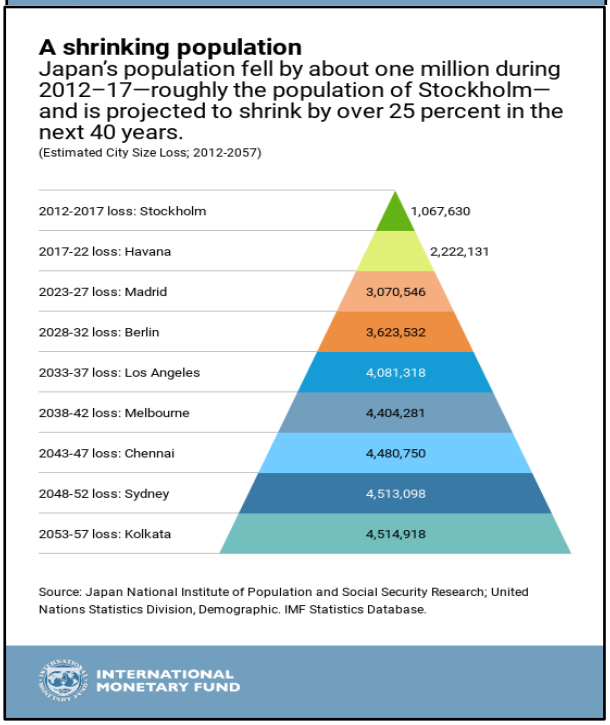
So the focus should be on household welfare and accessible bundle of services to the elderly. Each society should decide on what is the bundle of services needed in its current context, and be prepared to change as demographic conditions and expectations change.

The aim is to enable purchases of bundle of goods, services and assets on a life-cycle basis

Components of Household Welfare over a Life-cycle:

- Market Activities (including household Production) for income generation;
- Non- Market Activities: These involve healthy and productive lifestyle management to reduce expenditure needs at different phases of life, including retirement.
- This involves the provisioning of tangible & intangible services across society – governments, civil society, families, and businesses – for which provision by the market and by the public sector are often imperfect substitutes.
- Financial preparedness by individuals and by the society as a whole is a vital component of the overall strategy and policies for the ageing population.
- Addressing financial preparedness for retirement is qualitatively a very different challenge when retirement period after institutional retirement age extends to 25 to 35 years.
- Yet retirement or withdrawal age from provident funds in many countries have remained below 60 years.
- Four examples of challenges in financing ageing: The first example is Japan.





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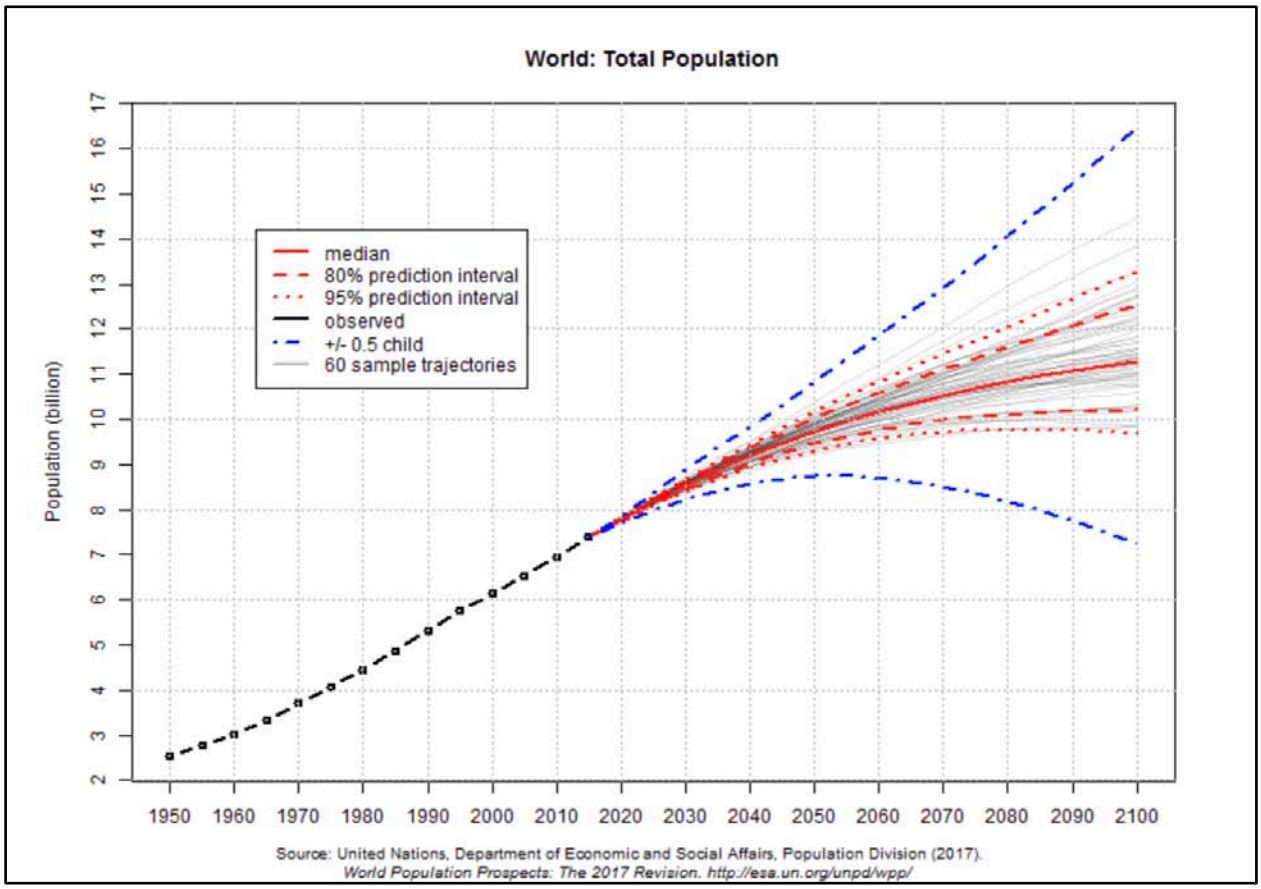
- The second example is Brazil in which pensions expenditure use up more than half of the federal budget and are growing at a rate four percentage points above inflation.
- This reflects the non-conducive political economy in pension arrangements.
- The third example concerns Taiwan where the ruling party, in response to official reports warning that an unreformed civil service and military pension systems could be bankrupt by 2020, has legislated significant cuts in their pension benefits to be implemented gradually over a decade.
- The fourth example is Korea which is facing a crisis cantered on poverty of the elderly. https://asia.nikkei.com/Spotlight/Asia-Insight/No-country-for-old-Koreans-Moon-faces-senior-poverty crisis?utm_campaign=RN%20Free%20newsletter&utm_medium=daily%20newsletter%20free&utm_source=NAR%20Newsletter&utm_content=article%20link
- These examples suggests that high middle income (Brazil), and high income countries such as Japan and Korea are required to m tough decisions to address the pension challenges of an ageing society.
- The middle income countries could study these examples and draw context-specific lessons from them.

II. Demographic Trends and Their Implications

Demographic trends pertain to all the persons in the world, and to their characteristics as consumers, workers, savers, and investors.

It affects income statements, and balance sheets in the world for:
Individuals
Households
Corporations and Companies
Government (Roy, 2018)

Variations in Global Population Projections



Source: World Population Prospects, 2017 Revision. Accessed on 16 December 2018

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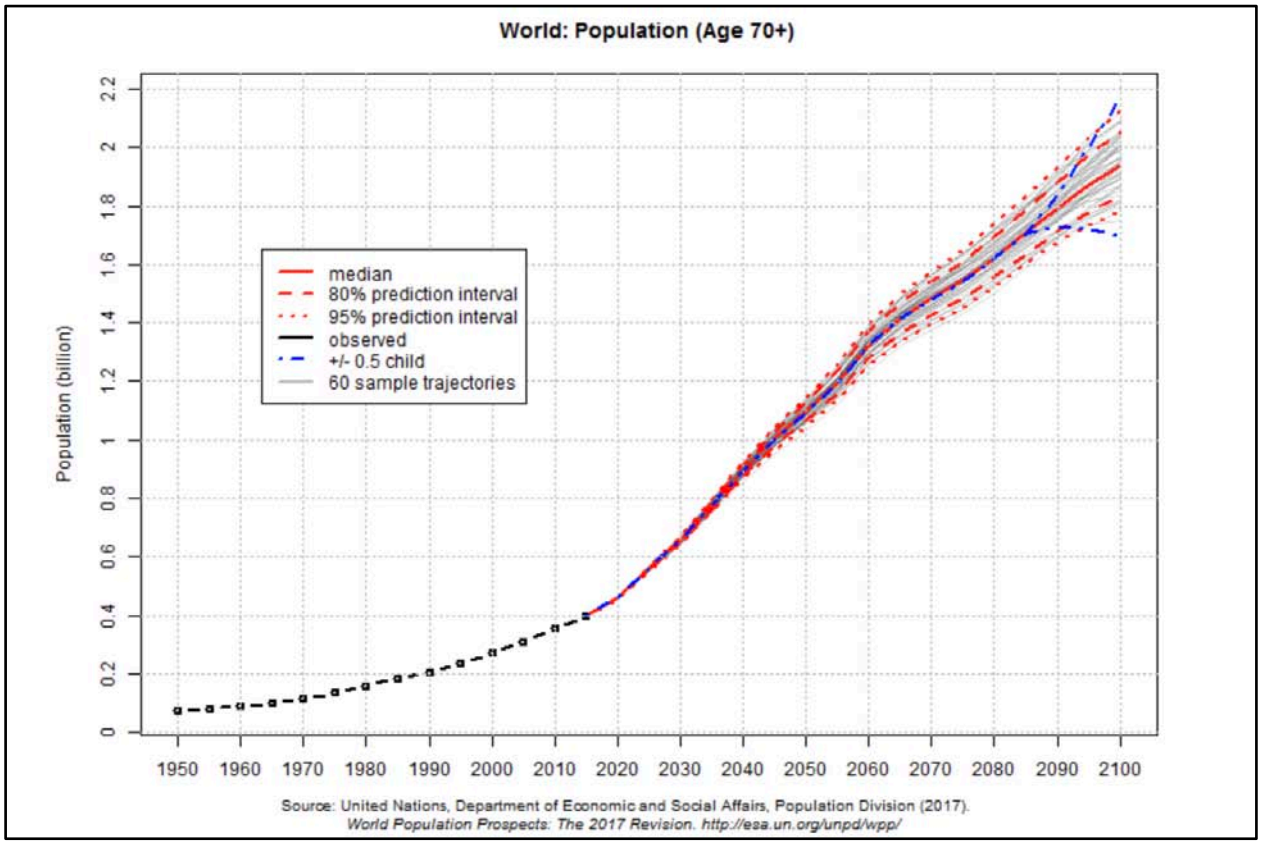
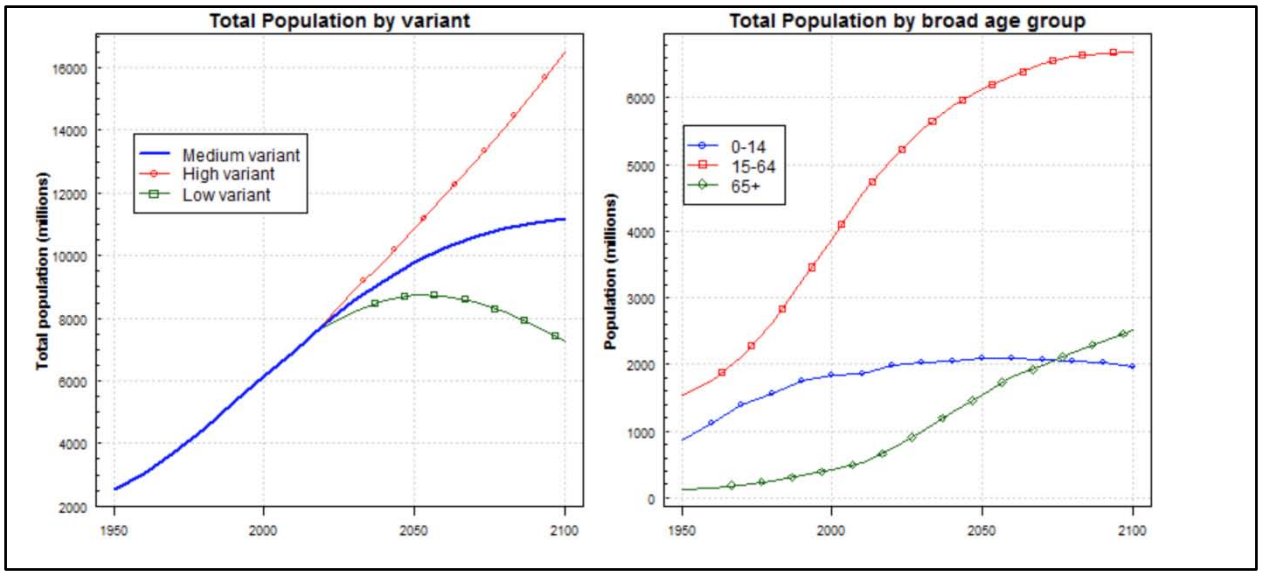
Variations in Age 70+ Population Projections



Demographic Profile Projections



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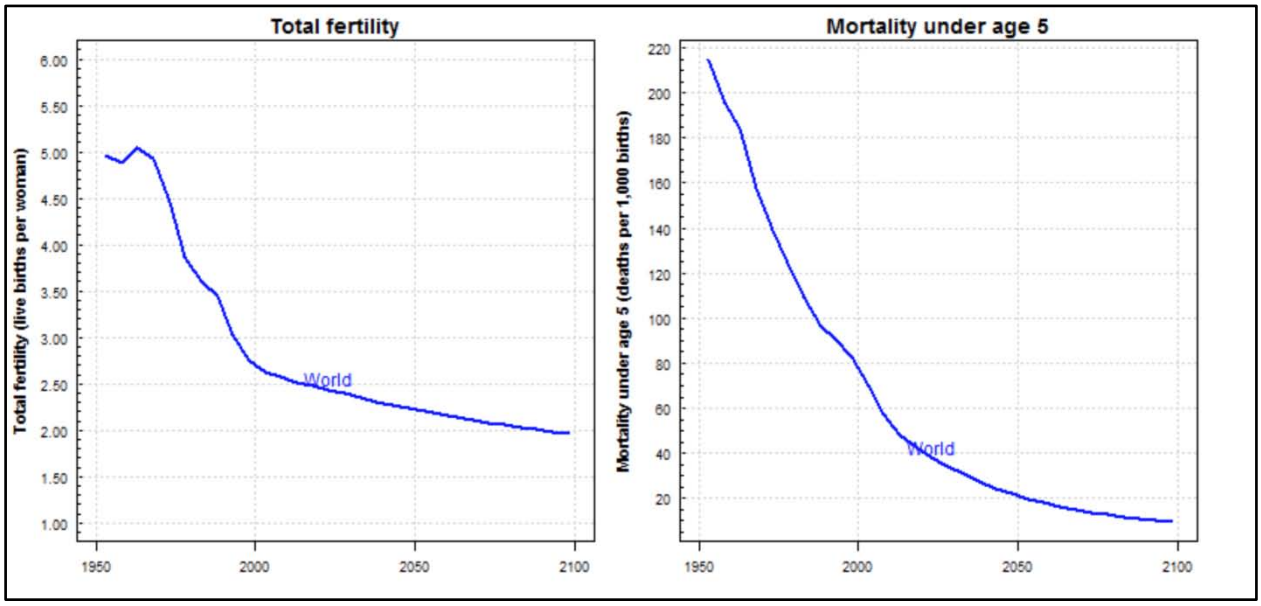
Demographic Profile Projections



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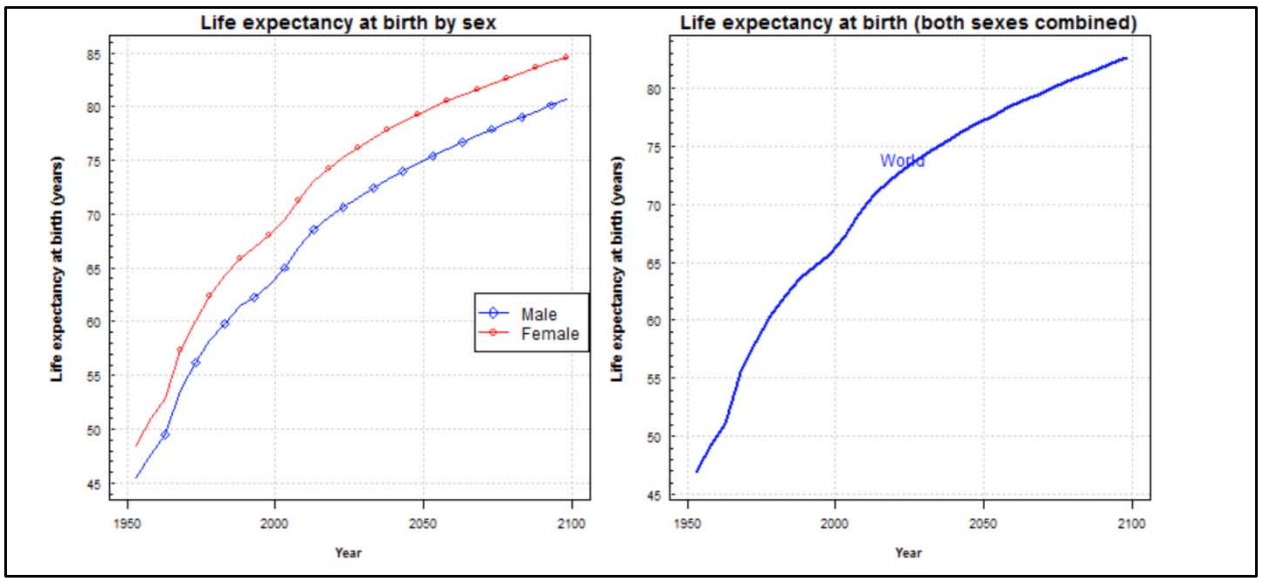
Demographic Profile Projections



Source: World Population Prospects, 2017 Revision. Accessed on 16 December 2018

a) For Savings

- Globally, proportion of retirement income derived:
- 46% from Government – suggests importance of sustainable public finances;
- 24 % from employer – suggests need for attractive business climate, and flexible labour market arrangements with reasonable growth in real wages;
- 30 % Own saving and investments – suggests the importance of sound long term saving policy and regulatory environment, and well-developed capital markets
- Source: AEGON Center for Longevity and Retirement (2018). The New Social Contract: a blueprint for retirement in the 21st century. https://www.aegon.com/contentassets/6724d008b6e14fa1a4cedb41811f748a/retirement-readiness-survey-2018.pdf
- How much individuals or households need to save through employer or by themselves depends on the country's pension system. (David Amaglobeli, Era Dabla-Norris, and Vitor Gaspar, 2019).

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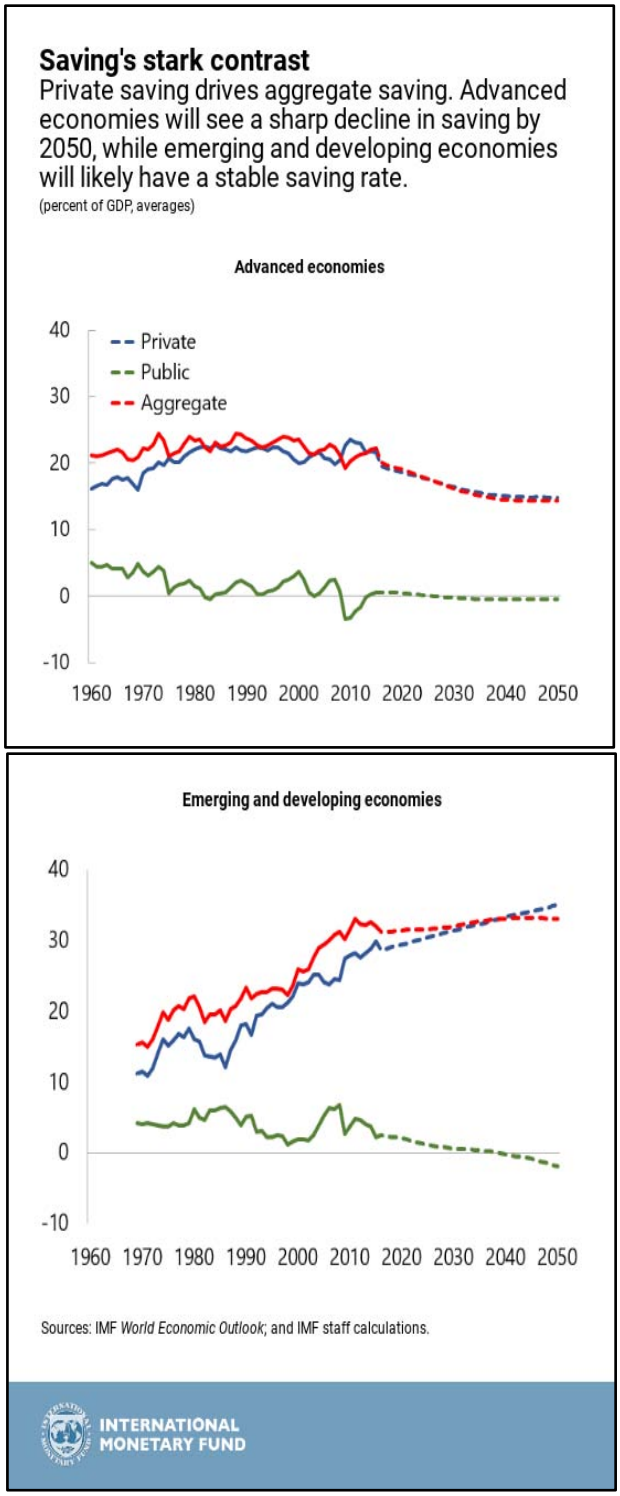

b) For Social Contract

- Several recent studies have advanced the theme that new social contract or substantial reforms of existing arrangements are needed to manage challenges, including financial preparedness of ageing populations.
- A brief overview of two studies is provided.
- The title of the study "The New Social Contract: A Blueprint for Retirement in the Twenty-First Century" (AEGON Center for Longevity and Retirement, 2018) strongly suggests reexamining the current thinking concerning retirement arrangements.
- The study states that financing pensions is qualitatively very different from institutional retirement periods extend from 25 to 35 years due to rising longevity. Yet, the retirement age remains low, in some countries, it is below 60 years.
- This study is based on a survey of 16,000 workers and retirees in 15 countries, including those in Asia.
- The study's context is the trends towards:
  i. Reduction in government retirement benefits;
  ii. Increasing longevity and reduced fertility rates;
  iii. Volatility in financial markets and prolonged low interest rate regimes;
  iv. Changing labour markets with a growing role for disruptive technologies;
  v. The increasing importance of the digital market place.
- The following findings of the study are particularly relevant:
  i. Nearly half of the people surveyed globally think that current retirement arrangements will make them worse of in terms of retirement income security.
  ii. Declining physical health is the most often cited retirement concern globally. Only a fifth of those surveyed confident of health care in retirement. Many stop working before retirement due to own or family member's ill health. So healthcare should be an integral part of financial preparedness for old age.
  iii. Only a quarter of those interviewed think they will achieve mean expected proportion of current earnings of 68% in retirement. Various avenues making up this 68 percent depends on many factors, including country's pension system.
- However, the recommendations for a New Global Retirement Model suggested by the AEGON study are relatively modest.
- Universal access to robust retirement savings system;
- Greater financial literacy;
- Affordable healthcare;
- The recommendations do not suggest what transitory steps and capacities will be needed to progress towards implementing their recommendations.
- The second study by Michal Rutkowski (2018) of the World Bank, titled "Reimagining Social Protection."
- He argues that new technologies, particularly digital technologies, are changing how people work and terms under they work.
- Around 3.5 percent of the global workforce works under the 'gig economy' type arrangements under

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which work is secured under short-term assignments, often via on-line. But this proportion is expected to grow.

- In addition, large informal sectors in emerging economies require pension and health care arrangements that are not nearly exclusively tied to formal long –term employment. Such employment has formed the basis on which the current welfare states have developed.
- He suggests greater use of budget financed social contracts, direct benefit transfers to the bank accounts of the beneficiaries of government programs (he gives India's direct benefits transfer program as an example to follow), and other uses of digital technologies (such as biometric card) to help improve access and level of benefits of social protection programs.

Demographic Indicators, Select Countries

	Population (mn)			Population> 65 (mn)			Population> 80 (mn)		
	2018	2030	2050	2018	2030	2050	2018	2030	2050
World	7632.8	8551.2	9771.8	680.9	996.9	1546.1	141.8	201.9	424.7
China	1415.0	1441.2	1364.5	158.4	245.9	358.9	26.7	40.8	111.0
Japan	127.2	121.6	108.8	34.9	36.8	39.6	10.6	15.2	16.3
Republic of Korea	51.2	52.7	50.5	7.4	12.6	17.8	1.7	3.0	7.2
India	1354.1	1513.0	1659.0	83.6	128.0	222.7	13.2	19.6	43.0
Indonesia	266.8	295.6	321.6	14.5	24.4	24.4	2.0	2.7	7.4
Malaysia	32.0	36.8	41.7	2.1	3.6	6.8	0.3	0.6	1.6
Philippines	106.5	125.4	151.3	5.2	8.4	14.9	0.7	1.1	2.7
Singapore	5.8	6.3	6.6	0.8	1.5	2.2	0.2	0.3	0.9
Thailand	69.2	69.6	65.4	8.2	13.5	19.0	1.7	2.7	6.6
Viet Nam	96.5	106.3	114.6	7.2	13.2	24.7	2.0	2.4	7.5

Source: World Population Prospects, 2017 Revision

Demographic Indicators, Select Countries

	Share of aged 65+ in total population (%)			Share of aged 80+ in total population (%)		
	2018	2030	2050	2018	2030	2050
World	8.9	11.7	15.8	1.9	2.4	4.3
China	11.2	17.1	26.3	1.9	2.8	8.1
Japan	27.5	30.3	36.4	8.4	12.5	15.0
Republic of Korea	14.4	23.9	35.3	3.2	5.6	14.3
India	6.2	8.5	13.4	1.0	1.3	2.6
Indonesia	5.5	8.3	13.8	0.7	0.9	2.3
Malaysia	6.5	9.7	16.3	1.0	1.6	3.7
Philippines	4.9	6.7	9.8	0.7	0.9	1.8
Singapore	13.6	23.2	33.6	2.7	5.2	13.3
Thailand	11.8	19.4	29.0	2.5	3.9	10.2
Viet Nam	7.4	12.4	21.5	2.1	2.2	6.5

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Demographic Indicators, Select Countries

	Total Fertility Rates (TFR)			Sex Ratio (SR)		
	2015	2025-30	2045-50	2015	2030	2050
World	2.47	2.39	2.24	101.8	101.6	101.0
China	1.63	1.69	1.75	106.3	106.1	106.0
Japan	1.48	1.58	1.70	95.5	94.8	94.8
Republic of Korea	1.32	1.46	1.63	100.2	99.5	97.4
India	2.3	2.10	1.86	107.6	106.8	104.7
Indonesia	2.32	2.12	1.90	101.5	100.3	98.3
Malaysia	2.01	1.86	1.74	106.9	104.7	102.6
Philippines	2.88	2.60	2.21	101.5	100.1	98.2
Singapore	1.26	1.30	1.37	97.6	97.6	96.7
Thailand	1.46	1.43	1.59	95.4	93.8	93.1
Viet Nam	1.95	1.92	1.90	97.9	97.7	96.8

Main Characteristics of Asian Pension Systems/1

- There are large variations in the robustness of Asian pension systems. Nevertheless, the following broad characteristics apply to them as a whole.

1. There has been less than adequate policy focus in Asia on financing arrangements; on developing professional provident and pension fund organizations, with appropriate governance and regulatory structures. These have resulted in high administrative and investment management costs; mis-selling of financial products; and less-than-adequate systems of coping with financial frauds which are increasingly directed at the elderly.
2. The above has resulted in lower coverage of the population with access to pensions (and to healthcare); lower number of risks being addressed, and when addressed, limited benefits are provided. This means that trade-offs between the adequacy of benefits, coverage of the population, and the extent of risks that are covered must be made for any given level of resource allocation to healthcare and to pensions.

Main Characteristics of Asian Pension Systems/2

In most Asian economies, a large share of healthcare expenditure is financed out- of-pocket, with limited risk pooling, though there is some progress towards social risk pooling, particularly in India and Indonesia. Thus, the focus should be on ensuring adequacy across all three dimensions, focusing only on the number of beneficiaries or statutory coverage is not very useful.

1. The main risks in retirement financing are:
   - Inflation risk – the risk that the real values of retirement income decreases with the inflation rate relevant for the consumption basket of the elderly);
   - Longevity risk – risk that retirement income may be inadequate in view of longer-than-anticipated life spans;
   - Survivors' risk – risk that survivors, particularly women and children, may not be adequately provided for.

In managing these risks, sufficient social risk pooling arrangements are essential as society, rather than individuals, are better able to bear them. In many Asian countries, this aspect is inadequately recognized by policymakers.

Societies as well as households need to rely on multiple sources from which financing for retirement is derived.

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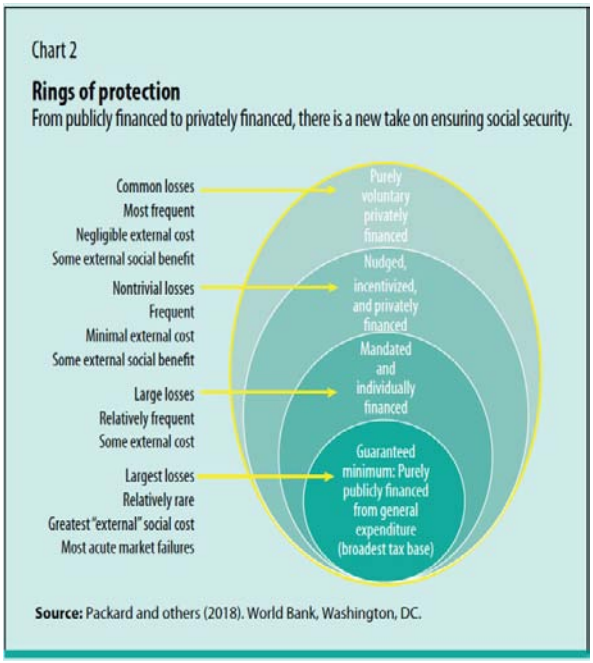

Main Characteristics of Asian Pension Systems/3

1. The financial and capital market development has been relatively limited. This has restricted investment options by provident and pension fund organizations, and by individuals. This increases investment risk both when retirement savings and social security contributions are made during working years; and during retirement periods when macroeconomic risk and annuities market risk need to be managed.
2. There is insufficient appreciation of the need to establish a strong data collection and analytical capabilities relating to pension arrangements, and to retirement behaviour. Regarding these data as a public good to be made available to various stakeholders should be accorded due priority. Such a practice would also enhance trust in the statistical systems and in provident and pension fund organizations. These are essential to undertake needed reforms with public support.
3. There is a strong case for establishing retirement behavior and pension research centers in most Asian countries, such as the Social Wellbeing Research Centre (SWRC) at Universiti Malaya. Such centres could address the issue of pension and healthcare policies being based on insufficient empirical evidence and policy research.
4. In many Asian countries, the political economy is not conducive to long-term and sustainable pension, retirement and healthcare policies. As a result, organizational, institutional, and regulatory arrangements which are conducive to long-term savings by households with confidence are relatively weak.
5. There is relatively less emphasis in promoting financial literacy among pension and provident fund trustees and staff, among policymakers, among households, and other stakeholders.
6. Asia has a large number of cross-border workers. They have very limited access to retirement income and healthcare benefits. Even when access is available, the costs are often prohibitive.

Select Issues in Financial Preparedness/1

Financial Literacy

- The importance of basic financial literacy has been recognized in helping to make appropriate choices for retirement income security.
- The consequences of poor financial choices could result in making mistakes with availing credit, spending retirement income too quickly or on inappropriate bundle of goods and services; and being defrauded by financial predators.
- As DeLiema et.al. (2018) have suggested, older persons are often targets of financial fraud. In U.S., where their data is derived from, most common frauds are investment frauds, and prize/lottery frauds.
- In other countries, including in Asia, frauds may involve different avenues. Financial fraud howere is a complex phenomenon. Increasing awareness, and raising requirements for ethical behaviour are likely to reduce the extent of the fraud.
- Four of the critical financial (and economic) literacy concepts for retirement financing are the following:
  1. The concept of compounding interest- the value of pension savings approximately doubles when 72 divided by the rate of interest earned on saving, e.g. if interest earned is 6%, the value of pension saving doubles every (72/6=2) years. This implies that retirement saving should start early in the working career and preserved until retirement.
  2. To understand the impact of inflation on household budgets, and in the case of public funding of pensions, on government budgets. Low inflation is, therefore, of significant benefit for retirement financing.
  3. The concept of risk diversification where overreliance on one source of retirement finance, such as property, children, state pensions, should be avoided.
  4. The concept of risk diversification cost: this refers to the alternatives forgone when choosing a particular retirement income avenue. Typically undue preference for current consumption reduce opportunity for adequate retirement financing.

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Select Issues in Financial Preparedness/3

Enhancing Financial Preparedness by Lowering Administrative Costs

- The higher administrative costs lower the real rate of return, which in turn reduces the adequacy of pension benefits; which further requires increased funding/i.e. pressures to create fiscal space.
- As an example, an administrative charge of one per cent of assets each year over a 40-year career, reduces the worker's accumulation (and hence his pension) by nearly 20 percent.

Decline in Value of Accounts Due to Fees

After a 40-Year Work Career a

Type and Level of Fees	Percentage Decline in Account Value Due to Fees
Front-load fees (% of new contributions) of:	
1 percent	1 %
10 percent	10 %
20 percent	20 %
Annual management fees (% of account balance) of:	
0.1 percent	2.2 %
0.5 percent	10.5 %
1.0 percent	19.6 %

A Assuming real wage growth of 2.1 percent and a real annual return on investments of 4 percent. With a larger difference between the rate of return and the wage growth rate, the charge ratio with annual management fees is slightly larger, and conversely.

Select Issues in Financial Preparedness/2

- It is not just the administrative costs that matter, but also cost of complying with the regulations, including receiving benefits without undue hassle costs and side payments.
- Compliance costs estimates are a relatively neglected area of research as well as of governance focus in Asia.
- Lowering compliance costs could improve adequacy for same level of monetary benefits; as well as improve fairness and organizational effectiveness.

III. Concluding Remarks

- The progress towards greater financial preparedness for old age will require all concerned pensioned related organizations, be it regulators, asset managers, service providers, as well as individuals and households to implement or to address the PHUI:

– Purpose of the organization – shifting from process to outcome orientation;
– Habits of stakeholders, including of officials of provident and pension fund organizations, as well as their trustees; and of individuals who will need to exhibit greater financial literacy.
– Using emerging technologies more competently and purposefully for record-keeping, lowering of administrative and compliance costs, and lowering investment management costs.
– Incentive structures for the organization, the officials, and the members to behave in a manner consistent with financial preparedness, and to enhance transparency and accountability.

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