Reintroduction of the Defined Contribution Pension Plan Bill

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The Defined Contribution Pension Plan Bill was reintroduced at an extraordinary session of the Diet in the middle of November. This report provides an overview of the bill and considers its likely impact.

1. Creation of a Defined Contribution Pension System

Existing corporate pension plans are of the defined benefit type (i.e., the benefits paid depend on an employee's salary and years of service). It has been pointed out, however, that, as well as not being universal (many small businesses do not offer one), such plans lack portability when a participant changes employers. They are therefore considered to be ill-suited to current employment conditions in Japan, where traditional practices such as "a job for life" and the seniority system are becoming untenable and employment increasingly insecure. Meanwhile, the poor performance of Japanese equities during the 1990s and low interest rates have led to a growing underfunding problem, and employers are having to make good the shortfall. Also, with post-retirement benefit accounting due to be fully adopted in Japan in fiscal 2001, employers will have to face up to their pension liabilities sooner rather than later.

As a result, there have been calls for a new type of pension system, and pressure has been mounting to adopt defined contribution pension plans, which are common in the United States. Moves to introduce legislation to this effect began in earnest in February 1998, when the Liberal Democratic Party announced a package of emergency economic measures and the matter was discussed by the four ministries concerned (the Ministry of Finance, the Ministry of Health and Welfare, the Ministry of Labor and the Ministry of International Trade and Industry). The final concrete results of this were the publication in December 1999 of ground rules for the tax treatment of such pensions plans. When the above bill was first introduced in the Diet on 6 March of this year, it had to be abandoned after the lower house was dissolved. However, at a meeting of the Liberal Democratic Party's Private Pension Subcommittee (chairman: Seiichi Ohta) on 5 September it was decided that the bill should be reintroduced at an extraordinary session of the Diet, therefore it was reintroduced in the middle of November. The following is an overview of the bill.

1) Main characteristics of defined contribution pensions

(1) Corporate pension plans and individual pension plans

The bill defines "defined contribution pension plans" as benefits paid to participants in their old age from moneys contributed by individuals or employers and invested on those individuals' instructions at their own risk (Defined Contribution Pension Plan Bill, Article 1).

Two types of defined contribution pension plan are envisaged: (1) corporate-type defined contribution pension plans (corporate pension plans) maintained either severally or jointly by companies (employers eligible to become sponsors under the Employees' Pension Fund) which pay contributions on behalf of their employees and (2) individual-type defined contribution pension plans (individual pension plans) maintained by the National Pension Fund Association, with contributions paid by individuals such as self-employed persons (Articles 2.1-2.4) (see Table 1).

Table 1 Main Features of Defined Contribution Pension Scheme

	Corporate pension plans	Individual pension plans
Plan sponsor	Employer	National Pension Fund Association
Plan agreement	Drawn up by agreement between employer and employees	Drawn up by National Pension Fund Association (without involvement of participants)
Contributors	Employer only	Individual participants only
Contributions	Calculated in accordance with plan agreement	Individuals can decide or change in accordance with plan agreement
Participants	Employees of company maintaining corporate pension plan	Self-employed persons and employees of companies that do not maintain a corporate pension plan (i.e., either an Employees' Pension Fund plan or a tax-qualified pension plan)
Choice of plan administrator	Plan administrator and fund trustee chosen by employer (who may perform these functions himself)	National Pension Fund Association chooses plan administrator (individuals choose an administrator for their own assets) and appoints a financial institution as a fund trustee
Qualifying event	Reaching age of 18; severe disability; death	
Types of benefit	Old age pension (lump sum or annuity), disability pension (lump sum or annuity), lump sum	
Tax concessions	● Companies can treat contributions as losses ● Individuals are not liable to income tax Members of Employees' Pension Fund: ¥216,000 per year Non-members of Employees' Pension Fund: ¥432,000 per year	Self-employed persons: ¥816,000 per year (i.e., the combined total of contributions to the National Pension Fund and individual contributions) Non-members of Employees' Pension Fund, a tax-qualified pension plan or a corporate pension plan: ¥180,000 per year

Source: NRI.

(2) Individually-based assets, investment instructions and fund transferability

The main characteristic of defined contribution pension plans is the fact that each participant's assets (i.e., those that are accumulated to pay future benefits) are administered separately and that participants are not only responsible for giving their own investment instructions (Articles 25 and 73) but can also either transfer those assets to another corporate pension plan or set up an individual pension plan when they change employers, provided they

fulfill certain conditions.[1] This is the reason the bill incorporates the concept of "portability" found in US 401 (k) plans. The bill envisages that the value of each participant's assets will be calculated according to government ordinance (Article 2.13).

"Investment instructions" refers to the fact that each participant must choose at least one investment from those recommended by his plan administrator and inform his record-keeper how much he wishes to allocate to each investment.

Individually-based assets may be transferred in one of three ways: (1) from a corporate pension plan to an individual pension plan; (2) from an individual pension plan to a corporate pension plan; or (3) from one corporate pension plan to another (Articles 80-85). Once a participant who is transferring his assets qualifies for membership of a new defined benefit pension plan, the National Pension Fund Association and the manager of his existing corporate pension plan are responsible for arranging the transfer.

2) Taxation

The extent to which defined contribution pension plans receive preferential tax treatment will be a major factor in whether they gain acceptance. How far the government was prepared to go became clearer when the General Outlines of Revised Tax Measures for FY2000 were published.[2] Defined contribution pension plans are affected by tax regulation at three points: (1) when contributions are paid; (2) when contributions are invested; and (3) when benefits are paid.

As far as the taxation of contributions is concerned, employers can treat their contributions as tax-deductible expenses, while participants are not liable to income tax on contributions. The bill specifies the following limits on contributions for each type of contributor (i.e., the maximum tax-deductible amount): companies contributing to a corporate pension plan can contribute a maximum of ¥432,000 per year (¥36,000 per month) per participant, if they do not maintain plans under the Employees' Pension Fund, or ¥216,000 per year (¥18,000 per month) per participant, if they do.

As far as individual contributions to individual pension plans are concerned, the full amount is tax-deductible. The maximum tax-deductible amount is (1) ¥816,000 per year (¥68,000 per month) per participant (i.e., the combined total of contributions to the National Pension Fund and individual contributions), if the contributor is self-employed and a Class-1 member of the National Pension Fund, and (2) ¥180,000 per year (¥15,000 per month), if the contributor is not covered by the Employees' Pension Fund and is an employee of a company that does not have a corporate pension plan (i.e., if he is a Class-2 member of the National Pension Fund).

As far as taxation of contributions to existing pension schemes (i.e., Employees' Pension Insurance and the Employees' Pension Fund) is concerned, companies can treat all their

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1 If a member of a corporate pension plan leaves the company concerned, he is entitled to receive benefits from the plan provided he has been with the company for at least three years (Article 4.1.7).

2 The details are contained in an appendix to the bill. They were not included in the tax revisions ("Revisions to Part of the Special Taxation Measures Law") promulgated on 31 March of this year. In addition, the bill itself calls for tax relief for defined contribution pension plans (Article 86).

contributions as losses while individuals can treat all their contributions as social insurance premiums (i.e., as tax-deductible). Defined benefit pension plans will therefore offer quite limited tax advantages compared with existing pension schemes.

As far as the taxation of contributions when they are invested is concerned, moneys accumulated in the fund and investment returns are exempt from tax until they are paid as benefits. However, moneys accumulated in a pension fund will be subject to a special corporation tax (and corporate resident tax) of 1.173%—just like tax-qualified pension plans. In April 1999, the special corporation tax was frozen for two (fiscal) years and will remain frozen until March 2001.

The taxation of contributions when they are paid out as pension benefits depends on the form in which they are paid. When they are paid as an annuity, they are exempt from tax because of their status as a public pension; but, when they are paid as a lump sum, they are subject to tax on retirement income, and the number of years a participant has been in a plan is counted as years of service.

Also, if a participant changes his employer and wishes to transfer his pension assets from one defined contribution pension plan to another, he may apply for the assets to remain exempt from tax. There are also tax provisions if someone wishes to transfer his pension assets from a defined benefit pension plan to a defined contribution plan.

2. Fiduciary Responsibility and the Administration of Corporate Defined Contribution Pension Plans

1) Administration

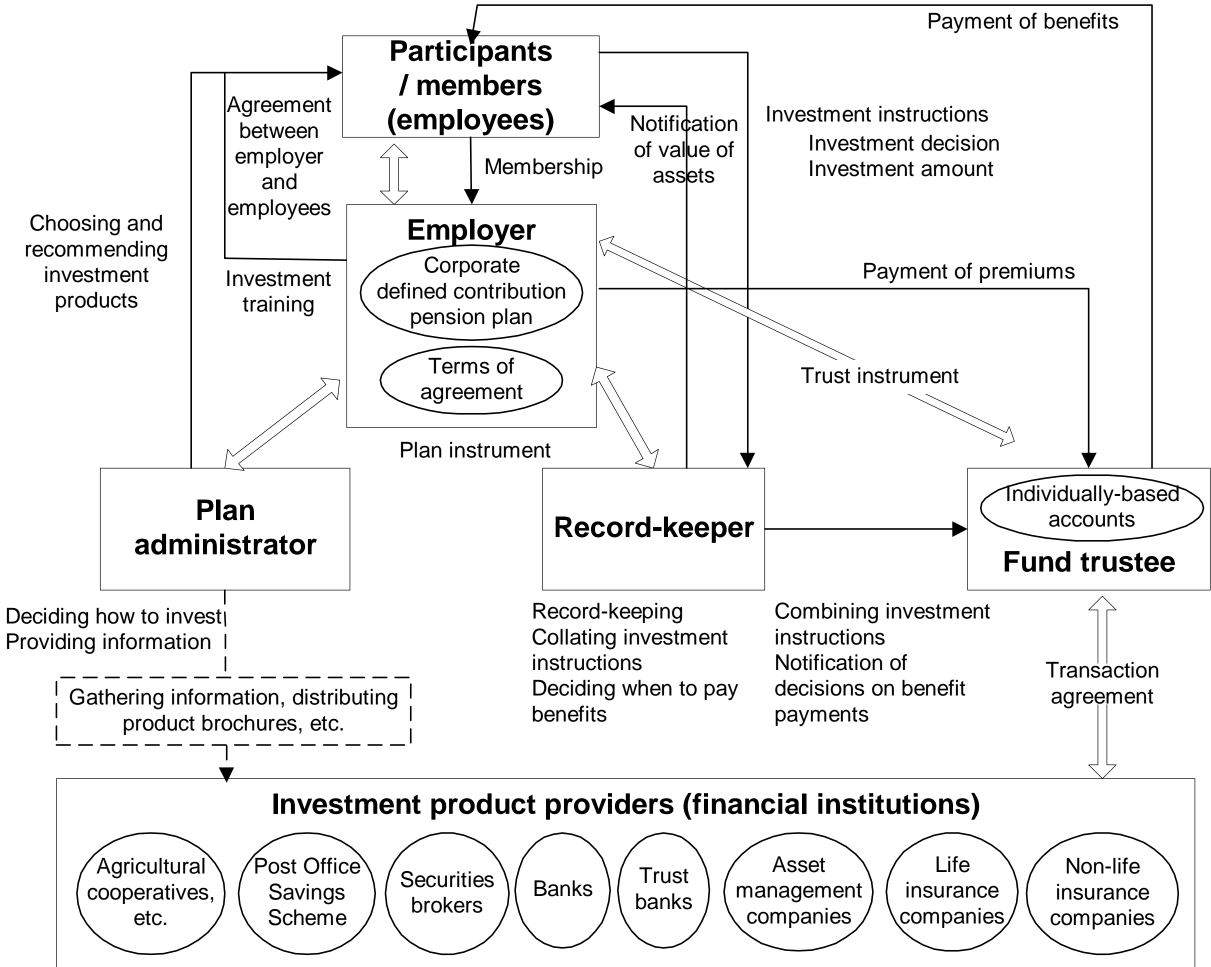
The main person responsible for administering a corporate pension plan is the employer. He is responsible for ensuring that his employees (here referred to as "participants") fully understand the terms of their plan and are able to give instructions on how the contributions he pays into their plans ("individually-based pension assets") should be invested (Articles 22-27). For example, he must do everything necessary to ensure that participants have the basic investment information they will need in order to do this (Article 22). In this connection, "everything necessary" refers, for example, to the kind of investment training participants will need in order to be able to make investment decisions by themselves.

The employer is also responsible for administrative arrangements—i.e., for both record-keeping (e.g., recording and storing data on plan participants, keeping them informed and collating their investment instructions) and administering the plan (e.g., choosing suitable investment products and recommending them to participants, as well as providing them with information on these investments) (Article 2.7). An employer can either administer a plan himself or entrust all or part of his responsibilities in this respect to a plan administrator, who, in turn, may entrust some of those responsibilities to another administrator (Article 7.1-7.2). An employer can also entrust to a plan administrator his responsibility (under Article 22) for providing basic investment information (Article 97). An employer must also sign a trust agreement with a trust bank or an insurance company (the "fund trustee") on the moneys being accumulated in the fund to pay future benefits in order to preserve the value of the

individually-based assets (Article 8). The employer must also remit contributions to the fund trustee by the end of the following month (Article 21) and inform the record-keeper (where he does not perform this function himself) of the amounts to be paid into each participant's account (Article 21.2). Finally, he is obliged to provide the record-keeper with certain information specified by Ministry of Health and Welfare and Ministry of Labor ordinances (Article 16).

Under the bill, the employer, plan administrator, record-keeper, fund trustee and the financial institution responsible for providing the financial products must sign agreements on how the pension assets are to be invested and administered (see Figure 1). Where the employer does not perform these functions himself, he may even, for example, sign third-party agreements (with the plan administrator and record-keeper acting on his behalf) or fourth-party agreements (to ensure that the financial institution providing the financial products provides them in good time).

Figure 1 Those Involved in a Corporate Defined Contribution Pension Plan



Source: NRI.

2) Code of conduct for employers and plan administrators

The bill defines the obligations of the plan administrator, etc. (the "plan fiduciaries") to participants (including a duty of loyalty and a prudence requirement similar to the ERISA "prudent man" rule, which requires plan fiduciaries to act with "care, skill, prudence and diligence") and lays down a code of conduct with penalties for infringements. In carrying out their obligations to plan participants, employers and plan administrators are subject to the relevant ordinances and penalties, and are required to adhere faithfully to the terms of their corporate pension plans (Articles 43.1, 44 and 99.1). This is to ensure that corporate defined contribution pension plans are run properly by ensuring: that participants are aware that they are responsible for how their pension assets are invested; that plan administrators follow the proper administrative procedures; and that employers carry out all their obligations as plan sponsors.

These regulations are similar to those incorporated in the US Employee Retirement Income Security Act of 1974 (ERISA) and are also due to be incorporated in the Corporate Pension Law due to be presented to the Diet next spring.

3. Impact of the Defined Contribution Pension Plan Bill

As well as making the necessary provisions for introducing a new pension system, the Defined Contribution Pension Plan Bill sets out stringent obligations and a code of conduct for all those involved. In the following I should like to deal with some aspects that employers and financial institutions responsible for administering plans should be aware of.

1) Responsibilities of employers (directors)

(1) Performance risk

Under the Employees' Pension Fund (the commonest type of corporate pension scheme), participants and their employers pay contributions into a corporate pension plan, from which benefits are later paid to participants on a predefined basis according to their salary and years of service. If the fund has not performed as well as expected and is unable to pay these defined benefits, the sponsor company will ultimately have to make good the shortfall. In other words, it is the sponsor company that bears the performance risk.

In the case of corporate defined contribution pension plans, however, it is only the company that pays contributions, while the participant is responsible for deciding how these are invested. It is therefore the participant—not the employer—who is responsible for how his pension plan performs. However, participants can be expected to become more performance-conscious than with defined benefit pension plans and may well put pressure on employers and those responsible for administering their plans. Particular care would have to be taken if it was decided to replace defined benefit pension plans with defined contribution plans.

(2) Employer's responsibility for monitoring plan administrator and fund trustee

Even after an employer has chosen a plan administrator and fund trustee, he cannot simply transfer all responsibility to them but is obliged to monitor them constantly. For example, if a plan participant suffers an unavoidable loss because an employer has failed to warn a plan administrator to change the way a plan's assets are invested or to change the plan administrator in spite of the fact that the plan has performed relatively badly, that employer will be held responsible.

If, as a result of such monitoring, an employer decides to change the plan administrator or the fund trustee, he must be sure to do the following. If the plan administrator has been negligent, the employer must either administer the plan himself or find another plan administrator and request him to take over. If the fund trustee has been negligent or if the trust agreement has been revoked, the employer must sign a trust agreement with another fund trustee and entrust him with the management of the pension fund (Articles 7.3, 8.3 and 4).

An employer is personally responsible for having and implementing his own standards for choosing and monitoring plan administrators and fund trustees. A number of publications are available to help him do this: the "Guidelines on the Roles and Responsibilities of Persons Involved in Managing the Assets of Employees' Pension Fund Plans" (Ministry of Health and Welfare, April 1997), the "Handbook of Fiduciary Responsibilities of Fund Directors " (Employees' Pension Fund Association, March 1998) and the "Handbook of Fiduciary Responsibilities of Fund Managers" (Employees' Pension Fund Association, April 2000).

2) Responsibilities of financial institutions

(1) Vendor services (plan administration, fund management and financial service) and conflicts of interest

One particularly tricky area with regard to duty of loyalty is that of conflicts of interest between plan administrators/fund trustees and participants. Although the Defined Contribution Pension Plan Bill does contain provisions that, to all intents and purposes, prohibit conflicts of interest involving employers and plan administrators (Articles 42.3, 42.4 and 100.5), there are no provisions prohibiting vendors from offering to provide both plan administration and fund management services, and no provisions clearly prohibiting formal conflicts of interest (such as when the same plan administrator or companies from the same group are responsible for both selecting and offering products) inasmuch as the bill allows fund trustees to be both plan administrators and financial institutions managing pension fund assets.[3]

In fact, where a plan administrator responsible for recommending how plan assets should be invested recommends only its own products, it could find its responsibilities onerous depending on how the bill's provisions governing duty of loyalty are applied (e.g., if there was formally a risk that it might be seeking to further its own interests or those of a third party). This is particularly tricky when, as in the United States, a single financial institution (or several financial institutions from the same group) acting as plan administrator provide all a defined contribution pension plan's vendor services (e.g., investment product selection,

3 The Law on Investment Trusts and Investment Companies explicitly defines those prohibited activities that would constitute a conflict of interest for an investment trust company.

investment training, record-keeping and fund management). Plan fiduciaries can expect to have to demonstrate that they have ensured that the quality and cost of such vendor services have benefited participants.

(2) Defined Contribution Pension Plan Bill and the Law on the Sale of Financial Products

Even if a plan administrator recommends particular means of investment, it is forbidden to try to influence a participant's investment instructions. This is because defined contribution pension plans assume that employers provide sufficient information on the key features of investment products (e.g., by explaining them to participants) and that participants receive sufficient investment training to enable them to make their own investment decisions. Both financial institutions acting as plan administrators and individual participants will have to adapt to a situation where either investment products are simply recommended and accepted or no investment advice is either given or sought.

Since the Law on the Sale of Financial Products was enacted in May of this year, financial product providers either selling or acting as agents or intermediaries for the sale of savings products, trust products, insurance products, securities or group investment products have been required to warn their customers that such financial products can fall as well as rise in value, and ensure that they understand the products' main features. Any financial product provider that fails to carry out this responsibility is obliged to compensate its customers for any loss they incur (Law on the Sale of Financial Products, Article 4). To ensure that financial product providers market their products properly, they are obliged to formulate and publish a marketing policy (Law on the Sale of Financial Products, Article 8).

The Law on the Sale of Financial Products is a comprehensive set of regulations governing the sale and marketing of financial products and will apparently not be applied to defined contribution pension plans. This is probably because the Defined Contribution Pension Plan Bill forbids plan administrators from trying to influence participants' choice of investment products and expects participants to be responsible for giving their own investment instructions. Therefore, a plan participant seeking compensation for a loss he has suffered as a result of inadequate information from the administrator of a defined contribution pension plan still has to demonstrate misconduct under civil law, and his burden of proof is not reduced by the Law on the Sale of Financial Products.

The administrator of a defined contribution pension plan is responsible for providing information on investment products. However, the investment products chosen may not necessarily be those of the plan administrator's company or an affiliated company. In such cases, the financial institution offering these products is responsible for explaining their features. In view of this, it is expected that some sort of legal provision will be made to ensure that the burden of proof on a plan fiduciary (whom one would expect to have a greater responsibility than if the investment had been made directly in a similar financial product) is not increased.

Another possible source of hope for aggrieved participants is the fact that the scandals that erupted in 1997 have had a major impact on the case law of financial products. Whereas, until the early 1990s, judges tended to support financial institutions (as "professionals") against compensation claims from people who had taken out variable pensions or invested in warrant bonds and claimed that they had not received an adequate explanation, in recent years

judges have tended to be much less willing to assume that financial institutions have behaved responsibly in this respect.

(3) Managing personal data

Plan administrators responsible for record-keeping will tend to accumulate data on individual plan participants. Personal data is a valuable marketing tool for financial services companies. However, to allow plan administrators to use such data other than for managing and paying out pension assets would be contrary to plan fiduciaries' responsibilities and seriously damage participants' interests. For example, trust banks could easily use the data they have collected as record-keepers for a defined contribution pension plan to market entirely different banking services to the plan's participants.

The question of how to prevent financial services companies from misusing customer data obtained in the course of business is likely to remain a thorny issue. In the United States, the authorities are treating it as a major problem and introducing legislation to tighten up on how customer data is managed.

The Defined Contribution Pension Plan Bill has anticipated the need for legislation on customer data and sets out clearly the responsibility of plan administrators to protect customer data in order to prevent confidential information obtained in the course of providing financial services from being misused. In so doing, the bill has established a precedent for future legislation on financial services. Companies providing a wide range of financial services will have to exercise considerable care when using and handling personal data (e.g., by obtaining permission in advance from customers about how they may use such data and by having a clear policy on handling it).

3) Future developments

With an eye to the introduction of defined contribution pension plans in the course of 2001 Japanese investment management companies are already making preparations (e.g., by training their staff, building call centers and Web sites that will enable customers to check the balance of their accounts and switch financial products, improving their record-keeping capabilities, and developing products, such as life-cycle funds, especially for defined contribution pension plans), investing large amounts of money, and targeting individual companies. Expectations appear to be high that the defined contribution pension plan business will become a mainstay of the investment management business. Following the bill's abandonment, there was considerable concern about when it might be reintroduced, but recently there appears to have been a sudden resurgence of interest.

If defined contribution pension plan participants are to gain a better understanding of the risks and other features of the investment products offered by their plans and provide adequately for their old age, employers and plan administrators will have to cooperate closely. The Defined Contribution Pension Plan Bill makes stringent demands on financial institutions involved in investment management to improve standards of conduct and levels of service. Investment management companies will be expected to develop a strong compliance capability to ensure that the growing demand for their services is not abused. New laws and revisions of existing laws governing investment management not only create new opportunities for investment management companies—they also set out clearly the

responsibilities of plan fiduciaries. New codes of conduct will have to be drawn up and adhered to—not least to cover existing financial products.

That is also why detailed guidelines on fiduciary responsibilities are needed. In Japan, a shortage of case law on investment management means that, rather than wait for case law to accumulate, the authorities would be better advised to set out guidelines (e.g., safe harbor rules) to ensure that defined contribution pension plan participants do not experience any unforeseen mishaps and that fears of misconduct do not prevent the new system from developing properly.

For the time being, the main concern is that the bill is enacted and implemented as soon as possible. Even then, however, there will still be a need for an expansion of preferential tax treatment and a review of the code of conduct governing plan fiduciaries in order to ensure that defined contribution pension plans gain acceptance in Japan.