Japan's Recent Defined-Benefit Corporate Pension and Defined-Contribution Pension Laws

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Bills on defined-benefit corporate pensions and defined-contribution pensions were enacted in June 2001. The Defined-Benefit Corporate Pension Law will come into force on 1 April, 2002, and the Defined-Contribution Pension Law on 1 October of this year. Together with the existing Employees' Pension Insurance Law, the two new laws establish common rules for administering and operating pension funds in Japan. Furthermore, with Tax-Qualified Pension plans due to be phased out by 2012, Japan's pension funds are facing a period of major reform.

1. Rapidly Changing Situation Faced by Corporate Pension Plans in Japan

There are two main types of corporate pension plan in Japan: the Employees' Pension Fund System (established in 1966) and the Tax-Qualified Pension System (approved in 1962). Employees' Pension Fund plans (EPF) are managed by independent pension funds which assume responsibility for managing a part of the state pension, “substitutional portion”, on behalf of the state. They enjoy certain tax benefits as well as being obliged to fund their liabilities and fulfill certain fiduciary responsibilities. On the other hand, Tax-Qualified Pension plans (TQP) do not contain the substitutional portion. Employers manage TQP based on the agreement between employers and employees, as far as requirements for tax qualification are fulfilled.

Since the mid-1990s, however, both of these types of corporate pension plan have had to face a number of problems as a result of rapid changes in investment conditions and demographics (a falling birth rate combined with increasing life expectancy).

First, (1) the sudden collapse in share prices that followed the boom of the late 1980s and (2) the exceptionally low levels to which interest rates have fallen since then have made it impossible for pension fund managers to achieve the assumed rate of return that forms the basis for retirement benefits under the two types of plan. While pension fund managers were able to outperform this target and generate a substantial surplus during the bull market of the late 1980s, the bear market of the 1990s and the exceptionally low interest rates since the mid-1990s have hit

investment returns. As a result, this surplus has become a ballooning deficit, and in 2000 the rate of return on investment was the lowest ever (–11.3%).

Furthermore, the adoption of post-retirement benefit accounting since the fiscal year ended in March 2001 means that companies with either EPFs or TQPs are now required to recognize any underfunding as a liability on their balance sheet. It is difficult for companies to control these costs as they vary with investment risk and any changes in the age structure of their work force.

In addition, EPFs face a problem because of the substitutional portion. Ever since such plans were introduced in 1966, they have contained this portion—partly to ensure that such plans are big enough to be viable. The fact that employers also have to make good any shortfall in this portion if their plans are in deficit has made the situation much more difficult. What is more, the fact that many plan participants select to take their benefits in the form of a lump sum (rather than as an annuity) means that in the not too distant future many such plans may find that the only funds they have left are those set aside to pay the portion.

At the same time, there has been a growing interest in the fiduciary responsibilities of the trustees and employers of such plans now that they are no longer straitjacketed by the investment regulations that used to govern the maximum proportion of a fund that could be invested in each of the four eligible classes of asset. Also, although the regulations on how TQPs may be managed have also been relaxed, the fact that such plans do not have the legal requirement about the funding level and fiduciary responsibilities means that the pressures on EPF sponsors have increased much more than those on TQP plan sponsors.

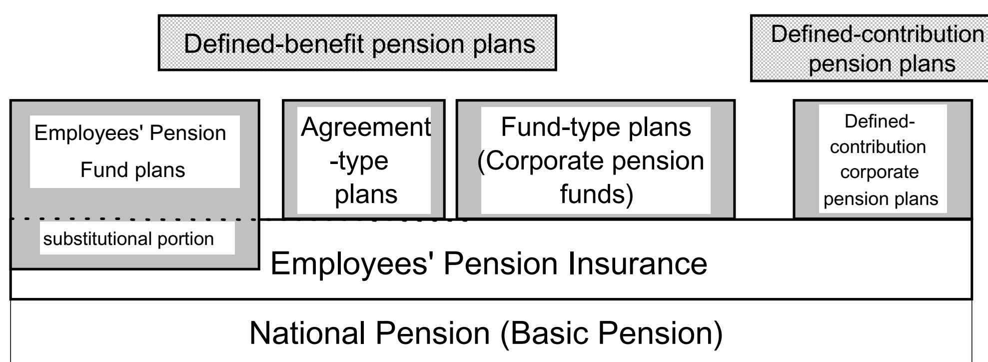
The situation has been further complicated by the fact that corporate restructuring and greater hiring of talented staff from outside have led to increasing demands for defined-contribution pensions as a flexible part of staff remuneration modeled on US 401(k) plans. Another factor behind the adoption of defined-contribution pension plans is the fact that, as individual participants are ultimately responsible for investment returns and as employer contributions are fixed, such plans relieve companies from some of the pressures on corporate earnings they face from defined-benefit plans (e.g., the need to increase employer contributions to offset rising retirement benefit liabilities and the changing age structure of plan participants).

2. Outline of Defined-Benefit Corporate Pension Law

The Defined-Benefit Corporate Pension Law creates two new types of defined-benefit corporate pension plan: agreement-type plans and fund-type plans. At the same time, TQPs are to be phased out by 2012. As a result, there will be four different types of corporate pension plan in Japan: three different types of defined-benefit plan (the agreement-type plans and fund-type plans that will be created alongside the existing EPFs) and the defined-contribution type of plan currently being introduced (see Figure 1).

The Defined-Benefit Corporate Pension Law creates common standards for defined-benefit plans: the structure of the two new types of defined-benefit corporate pension plan (see Figure 2), and funding, fiduciary and information disclosure requirements intended to ensure that participants' interests are protected. In addition, it lays down rules to enable companies to restructure their pension plans and switch from EPFs to defined-contribution plans (see Table 2).

Figure 1 Future Shape of Japan's Corporate Pension System



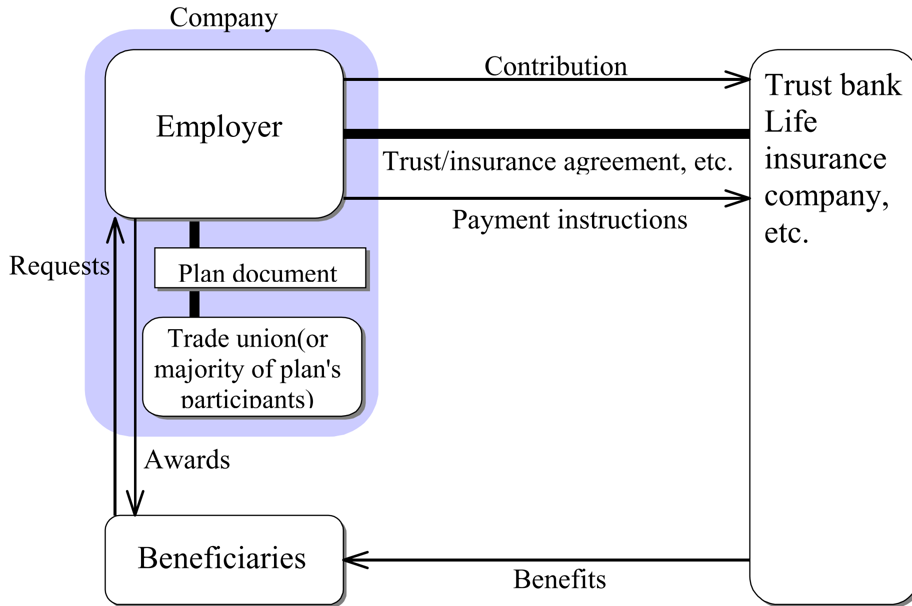
Note: The shaded areas are corporate pension plans.
Source: NRI.

1) The new defined-benefit corporate pension system

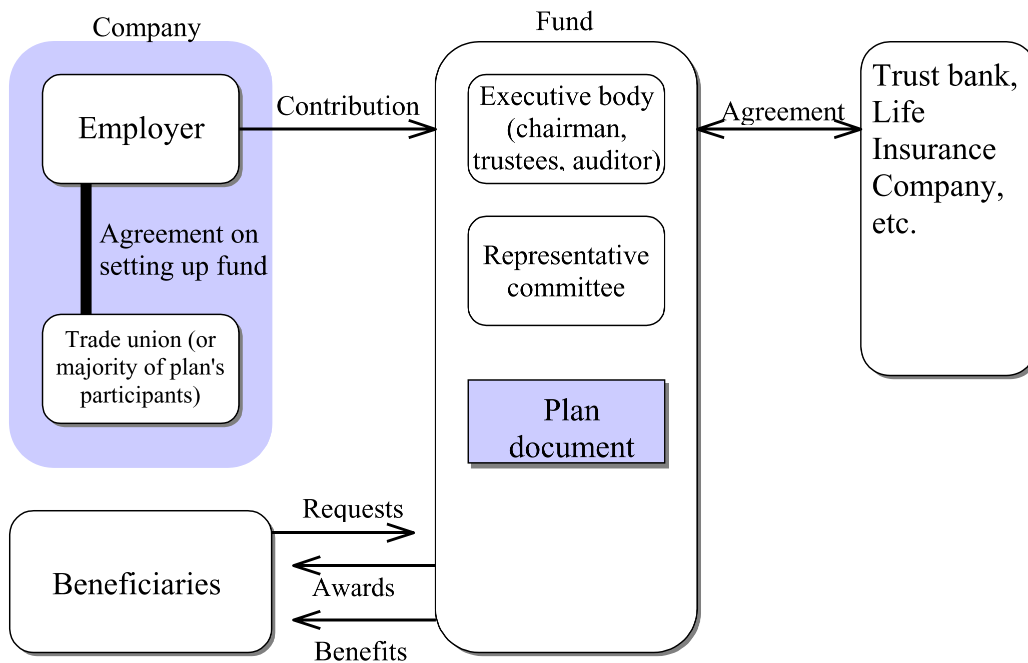
With an agreement-type corporate pension plan an employer is responsible for managing the company pension plan which is set up based on an agreement between himself and his work. He will also sign an agreement with a trust bank or life insurance company to have the plan's funds held in trust bank (custody) and managed externally, and benefits paid to eligible participants.

Figure 2 Two New Types of Defined-Benefit Corporate Pension Plan

(1) Agreement-type plans



(2) Fund-based plans (Employees' Pension Fund plans similar)



Source: NRI.

With a fund-type corporate pension plan a corporate pension fund is set up independently of the sponsor company to hold in custody and manage the plan's assets,

and to pay benefits to eligible participants. In order to set up a fund, a plan document has to be drawn up and permission obtained from the Minister of Health, Labor and Welfare. As with an EPF, the pension fund has to be governed by a representative committee, trustees and an auditor.

Table 1 Comparison of Different Types of Corporate Pension Plan

	Employees' Pension Fund plans	Defined-benefit corporate pension plans	Tax-qualified pension plans
Legal basis	Employees' Pension Insurance Law (system established in 1966)	Defined-Benefit Corporate Pension Law (system established in 2001)	Corporation Tax Law (system established in 1962)
Set-up	Requires approval of Minister of Health, Labor and Welfare.	Fund-type plans: requires approval of Minister of Health, Labor and Welfare Agreement-type plans: agreement signed with trust company, life insurance company, etc., and approval sought from Minister of Health, Labor and Welfare	Trust and insurance agreements require approval of Director of National Tax Administration Agency.
Sponsor	Employees' Pension fund	Fund-type plans: Corporate pension fund Agreement-type plans: Employer	Employer
Benefits			
(1) Level	Top-up benefits equivalent to at least 30% of the benefits from the substituional portion of the EPF	None specified	None specified
(2) Period	Whole-life annuity	At least five years	At least five years
Payment of contributions	As a rule, split equally between employers and employees. However, employers are responsible for paying most of the contributions towards top-up benefits. All plan participants also pay participants' contributions.	As a rule, employers are responsible for paying contributions, but individual participants may also pay contributions if they wish.	As a rule, employers are responsible for paying contributions, but individual participants may also pay contributions if they wish.
Funding requirements	Financial position has to be reviewed at least every five years. There is a minimum funding requirement.	Same as EPF plan (see left)	Financial position has to be reviewed at least every five years. There is no minimum funding requirement.
Fiduciary responsibilities	These define the responsibilities of and code of conduct for those involved in managing and operating plans.	Same as EPF plan (see left)	There are no statutory requirements.
Disclosure	Plan sponsors are required to disclose information on financial position of plans to participants.	Same as EPF plan (see left)	There are no statutory requirements.

Taxation			
(1) Contributions	Employer contributions: can be counted as a loss Employee contributions: can be deducted from tax liability	Employer contributions: can be counted as a loss Employee contributions: can be deducted from tax liability	Employer contributions: can be counted as a loss Employee contributions: can be deducted from tax liability
(2) Assets	Any amount in excess of 270% of the equivalent of the substitutional portion is subject to special corporation tax (currently suspended until fiscal 2002) at a rate of 1.173%.	Assets (other than those paid by participants) are subject to special corporation tax (currently suspended until fiscal 2002) at a rate of 1.173%.	Assets (other than those paid by participants) are subject to special corporation tax (currently suspended until fiscal 2002) at a rate of 1.173.
(3) Benefits	Annuity: taxed as income (with a deduction for public pension element) Lump sum: taxed as lump-sum pension (with a fixed deduction)	Annuity: taxed as income (with a deduction for public pension element) Lump sum: taxed as lump-sum pension (with a fixed deduction) (participant contributions excluded)	Annuity: taxed as income (with a deduction for public pension element) Lump sum: taxed as lump-sum pension (with a fixed deduction) (participant contributions excluded))

Source: NRI, from various sources.

Agreement-type plans are therefore similar to tax-qualified pension plans while fund-type plans are similar to EPFs. Also, unlike EPFs, the two new types of defined-benefit corporate pension plan do not contain the substitutional portion. The new plans can be managed as fully independent private-sector plans.

2) Actuarial evaluation and minimum funding requirement

As well as having to review their financial position every five years, employers and pension funds are required to recalculate the contribution rate of their plans whenever the number of the participants in a plan falls significantly (e.g., as a result of restructuring). They are also required to make good any deficit (e.g., by increasing contributions) within a certain period.

Employers and pension funds are required to accumulate the funds their plans will need to pay benefits as of the last day of each fiscal year. The value of this accumulated fund must not be allowed to fall below that of the plan's required reserves or its minimum funding requirement.

At the end of every fiscal year, company employers are required to recalculate their pension plan contributions if the value of their accumulated fund falls below the plan's required reserves or its minimum funding requirement and to pay an amount (based on the shortfall and calculated in accordance with the Ministry of Health, Labor and Welfare's directives) as a contribution. On the other hand, if, at the end of every fiscal year, the value of its accumulation fund exceeds the maximum amount its pension

plan is allowed to accumulate and if the excess amount exceeds the amount it pays as a contribution, the employer can take a "pension holiday" (i.e., he does not have to pay any more contributions). However (as with EPFs), employer contributions already paid cannot be refunded .

Finally, if a company decides to terminate one of the two new types of defined-benefit pension plan, the employer is required to pay as a single contribution the amount by which the value of the accumulation fund falls short of the plan's minimum funding requirement when the plan is terminated. He is also required to pay participants the full value of the fund's assets at that stage and may not have the money refunded.

3) Tax treatment

Theoretically Pension plans incur tax liabilities at three stages: when contributions are paid; when those contributions are invested; and when benefits are paid to participants. Under the present system of tax exemption on participant contributions, the full amount of contributions for EPFs is exempt but only the first ¥50,000 of contributions for TQPs.

The tax treatment of the two new types of defined-benefit corporate pension plan is based on that of TQPs. Pension benefits paid in the form of an annuity are liable to the same rate of tax as on miscellaneous income while benefits paid as a lump sum are liable to the same rate of tax as on retirement income. The assets of both plans are subject to special corporation tax at a rate of 1.173%. However this tax will be waived until fiscal 2002.

4) Fiduciary responsibilities and information disclosure

Now that pension fund management in Japan has been deregulated and those responsible for such funds (employers, pension funds and fund managers) enjoy greater discretion, they are required to demonstrate that they have fulfilled their fiduciary responsibilities by acting solely in the interests of beneficiaries (participants) and with a high degree of professional skill.

The assets of the two new types of defined-benefit corporate pension plan are legally and physically separate ("ringfenced") from those of their sponsor companies to ensure that beneficiaries' rights are not affected by events such as insolvency. In addition, fiduciary responsibility and information disclosure are now as important as the requirement that corporate pension plans are properly funded.

(1) Fiduciary responsibilities of agreement-type plan employers and fund-type plan trustees

Agreement-type plan employers and fund-type plan trustees have numerous responsibilities (ranging from when a plan is set up to when contributions are paid and invested, and when benefits are paid out). Employers are required to comply with the law, any administrative action by the Minister of Health, Labor and Welfare based on the law and with the plan document, and to maintain a duty of loyalty to plan participants. Similarly, trustees are required to comply with the law, any administrative action by the Minister of Health, Labor and Welfare based on the law and with the plan document as well as any decisions by their plans' representative committees, and to maintain a duty of loyalty to their plans.

Employers which manage a agreement-type plan, as well as trustees of a fund-type plan, are forbidden to do anything (as laid down by the Minister of Health, Labor and Welfare) that would impair the way a fund is administered or its assets invested, including (1) signing an agreement of plan management for the financial benefit of either themselves or any third party other than the participants of that plan and (2) instructing a fund's managers to invest its assets in a particular way Although trustees' work may involve assisting the chairman of the board of trustees (in accordance with his instructions) in how a fund is administered and its assets invested, trustees are jointly and severally responsible for compensating a fund for any failure by them to carry out such work properly.

Agreement-type plan employers are required to sign agreements with external managers (trust banks, life insurance companies or agricultural cooperative associations) for their funds to be administered and their assets invested. They may also sign agreements with asset management companies for them to manage assets covered by a trust agreement. Fund-type plans may also sign agreements with banks for assets to be held in a deposit or savings account or manage a fund's assets internally by signing a securities trading agreement with a securities company. However, any plans that manage their funds internally are required to sign an administration entrustment agreement with a financial institution. Employers are required to invest the assets of such funds in a way that produces a satisfactory return at low risk (in accordance with the law) .

(2) Fiduciary responsibilities of fund managers and custodians

Fiduciary responsibilities are not confined to the employers and trustees of the two new types of defined-benefit corporate pension plan: the fund managers and custodians also have such responsibilities.

In the case of agreement-type plans, fund managers, custodians and investment advisors are required to comply with the law and any agreements they have signed to administer and manage funds, and to maintain a duty of loyalty to plan participants. Similarly, in the case of fund-type plans, any party that has signed an agreement with a fund to administer and manage its assets is required to comply with the law and any agreements it has signed to manage assets, and to maintain a duty of loyalty to plan participants.

The new legislation contains new rules governing the fiduciary responsibilities of fund managers and custodians signing an agreement with an EPF. For example, fund managers and custodians signing a trust, insurance or mutual aid agreement with an EPF or a discretionary asset management agreement, an agreement on how assets will be invested or an entrustment agreement to administer a pension benefit fund are also required to maintain a duty of loyalty and care to plan participants directly.

5) Relationship between the various types of corporate pension plan

TQPs are popular with small businesses in Japan because of their tax benefits, the flexibility they offer with regard to retirement benefits (based on an agreement between an employer and his work force), and their low set-up costs. Under the new system, TQPs are due to be phased out and replaced by the two new types of defined-benefit corporate pension plan by 31 March, 2012 (i.e., in the next 10 years), and no new plans will be permitted from 1 April,2002.

TQPs are therefore expected to be replaced by one of the two new types of defined-benefit corporate pension plan, EPFs or the Organization for Workers' Retirement Allowance Mutual Aid. However, the fact that the two new types of defined-benefit corporate pension plan are much less flexible than TQPs with regard to funding requirements, fiduciary responsibilities and information disclosure means that many of the 96,000 or so TQPs currently run by small businesses are more likely to be simply wound up rather than replaced by one of the two new types of defined-benefit corporate pension plan.

The two new types of defined-benefit corporate pension plan can be replaced by an EPF and vice versa. To begin with, any conversions are more likely to be from EPFs to either of the new types of defined-benefit corporate pension plan. Any such conversion will involve repaying the substitutional portion. The problem here will be how EPFs should pay back to the state the reserves they have accumulated to cover this element. Payment can take the form of securities (such as government bonds and stocks) as well as cash. Legislation is on the way that will lay down the rules for

payment other than in cash. Payment in the form of domestic shares will apparently have to be in the form of a basket that tracks TOPIX.

3. Outline of Defined-Contribution Pension Law

The Defined-Contribution Pension Law is a response to changing attitudes to employment and efforts by companies to offer their employees a greater choice of remuneration. Defined-contribution pension plans set up individual accounts, thereby enabling people to take their pension assets with them when they change jobs ("portability"). We shall now look at the following aspects of the Law more closely: (1) portability, (2) the administration and running of defined-contribution pension plans, and (3) employers' fiduciary responsibilities.

1) High degree of portability

There are two different types of defined-contribution pension plan: corporate plans, where a company (employer) runs a plan either by itself or together with other companies (employers) and pays contributions on behalf of its employees, and individual plans, which are run by the National Pension Fund Association and into which self-employed persons and other individuals pay contributions (Defined-Contribution Pension Law, see Table 2). In both types of plan, participants have their own accounts and are responsible for telling the fund manager how their assets should be invested. How successful they are at this will determine the pension account they receive when they retire.

Table 2 Main Features of Defined-Contribution Pension Plans

	Corporate pension plans	Individual pension plans
Sponsor	Employer	National Pension Fund Association
Plan document	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 document	Individuals can decide or change in accordance with plan document
Participants	Employees of company maintaining plan (Class-2 participants of National Pension Fund below age of 60)	Self-employed persons (Class-1 participants of National Pension Fund) and employees of companies that do not maintain a corporate pension plan (i.e., non-participants of a corporate pension plan)
Choice of plan administrator	Plan administrator (plan administrator and record-keeper) and custodian chosen by employer (who may perform these functions himself)	National Pension Fund Association selects plan administrator (individuals select an administrator for their own assets) and appoints a financial institution as custodian
Qualifying event	Reaching age of 60 (benefits are not payable before then); severe disability; death	

Types of benefit	Old-age pension (lump sum or annuity), disability pension (lump sum or annuity), lump sum, death benefit	
Tax concessions (maximum contributions)	• Companies can treat contributions as expenses or losses • Individuals enjoy a maximum (annual) income tax allowance Participants of corporate pension plan: ¥216,000 Non-participants of corporate pension plan: ¥432,000	• Individuals enjoy a maximum (annual) income tax allowance Self-employed persons: ¥816,000 (i.e., the combined total of contributions to the National Pension Fund and individual contributions) Non-participants of a corporate pension plan: ¥180,000

Source: NRI.

In defined-contribution corporate pension plans it is the employer who decides to set up a plan, which is then operated on the basis of an agreement between him and his employees. In individual pension plans it is self-employed persons and other Class-1 participants of the National Pension Fund or employees of companies that do not have a corporate pension plan.[1] If a self-employed person wishes to join an individual pension plan, he must first apply to the National Pension Fund Association and then select an institution to manage his pension assets. He must tell the institution how he wishes these assets to be invested and pay contributions each month.

The main differences between defined-contribution pension plans and other pension plans are: that participants' assets are administered in individually based accounts; that participants are themselves responsible for how their assets are invested; and that participants who change employers and satisfy certain conditions[2] can transfer those assets to another individual pension plan without interrupting the participating period necessary to be eligible for retirement benefits and can continue to enjoy the tax advantages of participation. In fact, an individual can transfer his pension assets—from one defined-contribution corporate pension plan to another, from a defined-contribution corporate pension plan to an individual pension plan, or from an individual pension plan to a defined-contribution corporate pension plan—every time he joins a new plan.[3]

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1 Civil servants and full-time housewives (Class-3 participants of the National Pension Fund), and participants of a corporate pension plan are not eligible to join. For example, unless a company with an EPF decides to introduce a defined-benefit pension plan, its employees will not be eligible to join an individual pension plan, either.

2 If a participant of a defined-contribution corporate pension plan has to leave it because he is leaving his company, he is entitled to benefits from the plan's accumulation fund provided he has at least three years of service with the company (Article 4.1.7).

3 However, if his new company does not have its own defined-contribution corporate pension plan, the employee will have to take out an individual pension plan. Also, if the new company has a different type of corporate pension plan, it will not be able to pay contributions to an individual pension plan.

2) Operating and administering a defined-contribution corporate pension plan

The employer is the person ultimately responsible for how a defined-contribution corporate pension plan is operated and administered. He is responsible not only for drawing up the plan document and paying the contributions for his employees (the plan's participants). He also has to ensure that participants are able to make their own investment decisions and that there is a system for issuing reports on how participants' investments are performing and for administering and reporting on the payment of benefits. In fact, the administrative load and complexity of this is such that employers are allowed to entrust operational and administrative tasks (such as maintaining participants' records, notifying them and offering them a choice of investments) to an external plan administrator.

The following are an employer's responsibilities at the different stages of setting up and operating a defined-contribution corporate pension plan (see Figure 3).

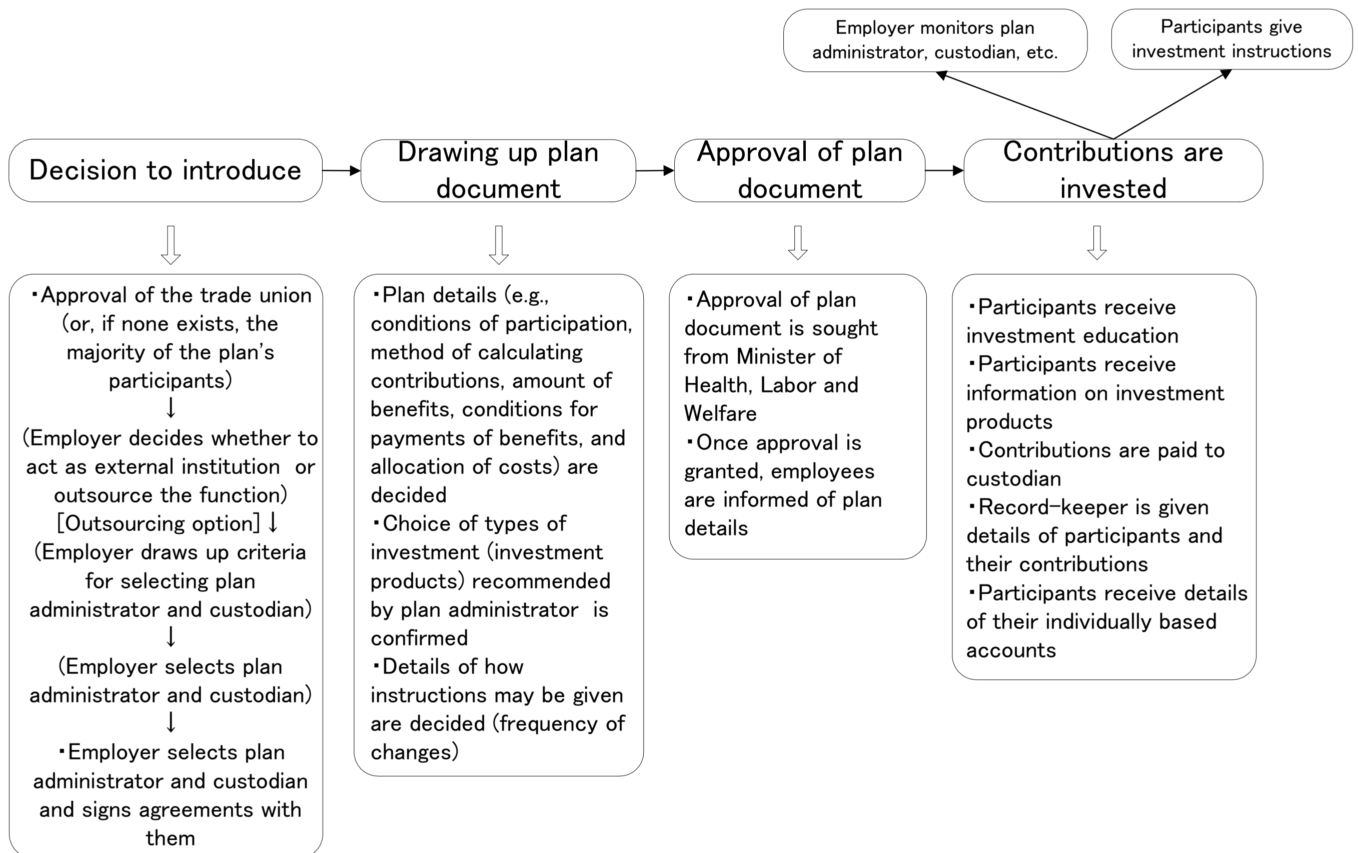
(1) Drawing up a plan document and informing participants

In order to set up a defined-contribution corporate pension plan, an employer has to obtain the agreement of his employees (the plan's participants, etc.[4]), draw up a plan document and have it approved by the Minister of Health, Labor and Welfare. The document must define: conditions of participation and how contributions will be calculated; what choice of investments will be offered and how participants can instruct record keeper; how benefits will be calculated and paid; whether the plan will be operated and administered externally; and how administrative costs will be apportioned. In addition, the document must define how investment products are selected and how often they can issue investment instructions.

Once an employer has decided to have his company's defined-contribution pension plan operated and administered externally, he should explain exactly the criteria and procedure for selecting the external institution to do this before signing any agreement and in accordance with his duty of loyalty (see below).

[4] The "plan's participants, etc." includes (1) full-time housewives who left the company before they became 60 and have not been eligible to join a individual pension plan and (2) participants of a corporate pension plan who have lost their right to participation (e.g., because they have reached the age of 60) and are therefore no longer entitled to contributions from their employer but are still entitled to decide how their assets are invested.

Figure 3 Different Stages of Setting Up a Defined-Contribution Corporate Pension Plan



Notes: 1 It is assumed that from the second stage ("Drawing up plan document") the employer has outsourced the functions of plan administrator (i.e.fund-selecting,record-keeping).

2 The items in parentheses under "Decision to introduce" are not required by law but are desirable in terms of duty of loyalty.

Source: NRI.

Once the Minister of Health, Labor and Welfare has approved a plan document, the employer must inform the plan's participants of the details as soon as possible.

(2) Arranging the investment environment

Participants of a defined-contribution pension plan are responsible for making their own investment decisions and instructing their plan's fund manager to invest their assets accordingly. [5] Employers must therefore provide participants of a plan (employees) who are not used to investing with a suitable investment environment (suitable investment products, investor education and adequate information). Employers are obliged to do everything necessary to achieve this, including ensuring that participants of their plan have access to basic documentation on investing their

[5] Although a plan administrator may offer a type of investment to plan participants, it is not allowed to advise their investment instructions.

assets. A principal task for employers may entrust this task to an external plan administrator.

One of the most important aspects of establishing a suitable investment environment is selecting the types of investment (investment products), and the Defined-Contribution Pension Law requires companies or plan administrators (1) to select at least three investment products from among deposit/savings accounts, trusts, mutual funds, equities, bonds, life insurance and non-life insurance policies, and offer them to plan participants; (2) to include among these at least one product where principal is guaranteed; and (3) to ensure that participants are able to give investment instructions at least once every three months.[6] Satisfying these requirements is also one of the conditions for approval of a plan document by the Minister of Health, Labor and Welfare.

The investment products that employers and plan administrators offer must be chosen "with professional investment expertise" . At the same time, participants must be given enough information about the returns and risks of these products for them to be able to give investment instructions. Furthermore, any change of investment product is regarded as a change of a plan document, and this requires the approval of both the trade union (or, if none exists, the majority of the plan's participants) and the Minister of Health, Labor and Welfare—a rather lengthy procedure. The choice (and especially the initial choice) of the products a plan's participants may invest in is therefore an important aspect of the investment environment that employers are required to establish.

(3) Preservation of individually based pension assets

An employer must sign a custodial agreement governing his plan's pension fund with an institution such as a trust bank or life insurance company (a "custodian") and endeavor to preserve participants' individually based assets. This is to ensure that these assets are both physically and legally separate from those of the sponsor company and to shield them from the effects of risks such as bankruptcy. The custodian, acting in accordance with the custodial agreement, (1) receives contributions payment from the employer every month, (2) passes on investment instructions received from the plan's record-keeper to the financial institutions that provide the plan's investment products, and (3) pays benefits to.

6 "Giving investment instructions" refers to the process whereby a plan participant selects at least one of a number of investment options recommended by his plan's fund manager, decides how much to invest in each investment product and whether to change this choice, and informs his plan's record-keeper.

As with choosing a plan administrator, an employer should make it clear what procedures and criteria he has adopted when choosing a custodian. This will enable him to convince plan participants that there is no possibility of any conflict of interest.

3) Fiduciary responsibilities of employers

Employers responsible for operating and administering defined-contribution corporate pension plans (and the plan administrators and custodians that support them) have a duty of loyalty and a duty of care to plan participants intended to ensure that they carry out their responsibilities. The aim of this is to ensure that defined-contribution corporate pension plans operate properly by (1) making plan participants aware that they are responsible for how their assets are invested, (2) clearly defining the responsibility of employers to establish investment procedures and (3) requiring employers to take their responsibilities as plan sponsors seriously.

In addition, employers are subject to rules of conduct that forbid, amongst other things, conflicts of interest and lay down administrative action for violating the rules. There is a rule requiring employers to comply faithfully with the law, any administrative action and with the plan document in the interest of plan participants and forbidding employers from signing an administration agreement for the financial benefit of either themselves or any third party other than the participants of that plan. As with employers, plan administrators[7] are required to comply with the rules of conduct, which, for example, forbid them (when they sign an administration agreement) from promising to make good any losses suffered by plan participants or from offering them any special benefits.

In spite of the fact that these rules also forbid plan administrators from doing anything that would conflict with participants' interests, the Defined-Contribution Pension Law allows banks providing financial products for a plan (or any financial institution allowed by government ordinance) to act as a plan administrator. Nor are plan administrators forbidden from both acting as custodians and providing financial products for a plan, although they are required to refrain from any activity that might conflict with their duty of loyalty. If financial institution acting as plan administrator on behalf of an employer selects any financial products, it is obliged to act in the interest of the plan's participants and to be wary of creating possible conflicts of interest (e.g., by recommending its own financial products and receiving a fee from the plan for providing these financial products). In such a situation, the institution

[7] Any company wishing to administer defined-contribution pension plans is required to register with the relevant Minister . The Minister exercises his right of control by requiring a plan administrator to submit written and give oral reports on its business activities, carrying out unannounced inspections and questioning the administrator's staff. If the Minister deems it necessary, he can take action against the administrator (e.g., by compelling it to suspend its operations or annulling its registration).

concerned would have to satisfy the employer not only that it had chosen the products with professional expertise, but also that there was no conflict of interest.

If a situation arose where plan participants suffered an unavoidable loss and the employer was found to have been guilty of either a conflict of interest in choosing a plan administrator or of failing to monitor the plan administrator properly, he would probably be called to account.

4. Issues Outstanding and Outlook

1) Defined-Benefit Corporate Pension Law

The enactment of the two new pension laws marks a significant step forward in that it gives companies the flexibility to customize their pension plans to their needs and those of their employees. However, a number of issues remain.

In recent years increasing international competition has forced companies to merge and restructure. As a result, corporate pension plans have also been forced to merge in a hurry. Under the current system, companies with an EPF that merge with companies with a TQP are not allowed to convert the former type of plan to the latter, which they have therefore no choice but to discontinue. Once the new pension laws come into force, however, they will be able to convert both EPFs and TQPs to either of the new types of defined-benefit pension plan. Labor in Japan is likely to become increasingly mobile as attitudes to work become increasingly diversified and companies become increasingly willing to restructure. Pension portability will be essential to this. However, neither of the new types of defined-benefit corporate pension plan currently offers this. Pension portability therefore needs to be addressed as a matter of urgency.

The next issue is that of guaranteeing pension benefits even if the sponsor company becomes insolvent. In Japan, no such system exists at the moment, but the matter is under discussion. US experience (in the form of the Pension Benefit Guaranty Corporation) suggests that such a system (whereby a company with a pension plan that is in good financial shape rescues one whose pension plan is in difficulty) violates the principle that employers are responsible for the contributions they pay into their pension plans and risks encouraging moral hazard.

In both agreement-type pension plans (where pension assets are accumulated externally with a financial institution) and fund-type plans (where a separate legal entity is set up), pension assets are shielded from creditors seeking to make good their claims if the sponsor company becomes insolvent. Also, the existence of strict funding

requirements means that Japanese corporate pension plans are unlikely to fail—even if there is no Japanese equivalent of the Pension Benefit Guaranty Corporation.

Third, in order to accommodate the needs of plans that wish to abandon the substitutional portion as soon as possible, the Defined-Benefit Corporate Pension Law will allow sponsor companies to be exempted from making good the shortfall that will occur if their representative committees decide to go ahead and apply to the Minister of Health, Labor and Welfare for approval. However, the fact that individual participants' benefits are defined means that the Social Insurance Agency will want to compare its own records of participants with the plans' records. As the necessary computer systems are now not expected to be ready until the autumn of 2003, the actual procedures have not yet been decided. Hopefully, however, plans that wish to abandon the contracted-out element will be able to do so as soon as possible.

Finally, major tax reforms will be needed if the new corporate pension plans are to gain early acceptance. All taxes on pensions should be based on the principle that contributions and investment returns should be free of tax, but benefits subject to it. In our view, therefore, special corporation tax, which would normally be levied on contributions to and returns on assets in an accumulation fund, should be reconsidered. Companies can count the contributions they pay as a loss while employees do not pay any income tax on their pension assets until they receive them as benefits. It has been said that special corporation tax is necessary to ensure that taxation is equitable—special corporation tax being the equivalent of interest on these deferred taxes. Leaving aside the fact that (at just over 1%) the rate of special corporation tax, which was set at a time when interest rates were higher than they are now, is relatively high, there are no examples of such a tax in other countries. We therefore hope that the tax will be abolished with immediate effect in fiscal 2002 so that it does not hinder the spread of the two new types of defined-benefit corporate pension plan.

2) Defined-Contribution Pension Law

In the run-up to the enactment of the Defined-Contribution Pension Law financial service companies (banks, securities companies, insurance companies, investment companies, and consultants) were busy preparing new investment products and services. With some financial service companies setting up plan administration departments (within either the parent company or the group) and others concentrating their efforts on developing investment products or consultancy services, all of Japan's financial services industry is seeking to be involved in one way or another in the defined-contribution pensions business. Similarly, companies such as Hitachi, Toyota and Skylark have shown a lead in announcing that they will set up such plans.

As part of the process of implementing the Defined-Contribution Pension Law, corresponding ordinances and rules were promulgated on 23 July,2001. Companies that are considering setting up a defined-contribution pension plan will soon have to decide what sort of plan to adopt. Although individual participants of defined-contribution corporate pension plans are responsible for their own investment decisions, this assumes that a suitable investment environment is already in place. Similarly, plan participants need to receive a proper investment education and sufficient information, while the choice of investment products is also extremely important as participants applying what they learn to their own investment decisions can only select their investment products from those offered by their plan.