Defined Contribution Pension Plans in Japan
- Current Status and Challenges -

Akiko Nomura

I. Debate about Defined Contribution Pension Plans in 2007

Defined contribution pension plans were introduced in Japan in 2001 as an additional option to existing pension plans. In Japan there are two types of defined contribution pension plan: (1) corporate plans for employees of private-sector companies and (2) individual plans for self-employed persons and employees whose employers do not offer any corporate pension plan.

Ever since defined contribution pension plans were introduced in Japan, a number of problems have been identified and the rules governing these plans have been amended several times. There have been a number of developments in recent years. In October 2006, the Ministry of Health, Labour and Welfare (MHLW)'s Pension Bureau set up a "Corporate Pension Study Group" to discuss the main issues surrounding corporate pensions including defined contribution pension plans (see below).[1]

Similarly, the Council on Economic and Fiscal Policy and the Financial System Council's Sectional Committee on the Financial System have both identified the need to expand defined contribution pension plans as part of the efforts to encourage households to shift their assets from savings (i.e., deposits) to investments.[2] Both the MHLW and the Financial Services Agency (FSA) have called for amendments to the existing system in their tax amendment proposals for FY08.

It is therefore probably fair to say that 2007 saw more debate on defined contribution pension plans than at any time since 2004, when contribution limits were increased. A bill to standardize the rules governing (public- and private sector) employee pensions that came before the Diet in April 2007 (the "Employee Pensions Standardization Bill") contained a number of amendments to the rules governing defined contribution pension plans. However, the only key tax-related amendment that was actually included in the Tax Reform Bill for FY08 was the urgent issue of

[1] See "Kigyo Nenkin Seido no Shiko Jokyo no Kensho Kekka" [Findings on the State of Corporate Pension Plans], Kigyo Nenkin Kenkyukai [Corporate Pension Study Group], July 2007.

[2] Referred to in the Council on Economic and Fiscal Policy's "Program for Enhancing Growth Potential" and "Basic Policies for Economic and Fiscal Management and Structural Reform 2007" as well as the Financial System Council's Sectional Committee on the Financial System's "(First) Intermediate Report of the Study Group on the Internationalization of Japanese Financial and Capital Markets."

continuing to suspend the special corporation tax. Many other issues were simply passed over.

Meanwhile, tax-qualified pension plans, a well established type of corporate pension plan (especially among small businesses) are due to be abolished in March 2012. In order to encourage as many companies as possible to retain some sort of pension plan instead of simply winding up their existing plan, more needs to be done to make defined contribution pension plans an attractive option.

This report examines the issues surrounding defined contribution pension plans in Japan and points out that the existing system needs to be reformed in view of various changes including those to defined benefit plans.

II. Current Status of Defined Contribution Pension Plans

1. Introduction of defined contribution pension plans by Japanese corporations

1) Replacement plans and new plans

As of end-March 2008 there were 2,710 defined contribution pension agreements in effect in Japan. As some of these are cases where either a group of companies or a number of individual companies join the same plan ("group pension plans"), the number of participating companies was much bigger (10,334). A breakdown of the participating companies by number of employees reveals that just under 60% tend to have fewer than 100 employees.

For some of these companies a defined contribution pension plan is their first pension plan; for others it replaces another type of plan. We can usually tell whether a defined contribution pension plan is a new plan, an addition to an existing plan or a replacement for an existing plan by whether any of its assets have been transferred from another plan. 61% of the companies with a defined contribution pension plan as of March 2008 had transferred some of their pension assets from another plan. If we assume that plans that have not transferred any of their assets are either new plans or additions to existing plans and that those that have transferred some of their assets are replacement plans,[3] it is apparent that many companies have adopted defined contribution pension plans as part of the process of modifying an existing plan (Figure 1).

[3] Cases are also possible where the existing pension plan has been wound up by paying a lump sum and setting up a defined contribution pension plan from scratch. Although such cases are counted as not having involved any transfer of assets, they should probably be regarded as having involved the introduction of a defined contribution pension plan as part of the process of modifying an existing plan.

Figure 1: Asset Transfers from Other Plans to Defined Contribution Pension Plans (by number of employees as of March 2008)

Occurrence of asset transfers

Number of employees	Transfer	No transfer
<99	53.3%	46.7%
100<299	71.8%	28.2%
300<999	72.6%	27.4%
1000<	70.2%	29.8%
Total	61.3%	38.7%

Note: Percentage of companies of different sizes in terms of number of employees.
Source: NICMR from Ministry of Health, Labour and Welfare's Pension Bureau data.

Type of plan from which assets have been transferred

Number of employees	Tax-qualified pension plan	Lump-sum payment plan
<99	75.3%	33.5%
100<299	75.2%	37.2%
300<999	66.6%	46.6%
1000<	46.7%	57.8%
Total	71.6%	38.5%

Note: Percentage of companies of different sizes in terms of number of employees. Companies with assets transferred from both types of plan are counted twice.
Source: NICMR from Ministry of Health, Labour and Welfare's Pension Bureau data.

A breakdown of pension plans by the type of plan they have transferred their assets from reveals that the vast majority have transferred assets from tax-qualified pension plans and that the next most common type of plan they have transferred their assets from is lump-sum retirement/severance payment plans. We assume that transfers from tax-qualified pension plans are a result of the reforms of 2001, according to which these plans are due to be abolished in March 2012 (see above). The fewer a company's employees, the more likely it is to have transferred pension assets from a tax-qualified pension plan.

2) Combination with existing plans

While some companies have introduced defined contribution pension plans as their sole pension plan, others have introduced them alongside other plans. Although 36% of companies offered them in combination with another plan, the proportion varied significantly according to the number of a company's employees, with only 25% of companies with fewer than 100 employees doing so, but as many as 69% of companies with 1,000 or more employees (Figure 2).

Figure 2: Combination of Defined Contribution Plans with Other Pension Plans (by number of employees as of March 2008)

Occurrence of other plans

Number of employees	Other plan(s)	No other plan(s)
<99	25.1%	74.9%
100<299	43.9%	56.1%
300<999	55.0%	45.0%
1000<	69.1%	30.9%
Total	36.4%	63.6%

Note: Percentage of companies of different sizes in terms of number of employees.
Source: NICMR from Ministry of Health, Labour and Welfare's Pension Bureau data.

Type of plan with which combined

Number of employees	Employees' Pension Fund plan	Defined benefit corporate pension plan
<99	57.9%	33.9%
100<299	52.2%	39.9%
300<999	36.5%	54.8%
1000<	19.2%	75.8%
Total	46.9%	45.2%

Note: Percentage of companies of different sizes in terms of number of employees. Companies with both an benefit Employees' Pension Fund plan and a defined corporate pension plan are counted twice.
Source: NICMR from Ministry of Health, Labour and Welfare's Pension Bureau data.

Of the companies that offered a defined contribution pension plan in combination with another plan, the other plan was often either an Employees' Pension Fund plan or a defined benefit corporate pension plan. The smaller the company, the more likely the other plan was to be an Employees' Pension Fund plan; while, the bigger the company, the more likely it was to be a defined benefit corporate pension plan. We think this is probably because many of the large companies that used to set up Employees' Pension Fund plans independently have already returned the part they managed on behalf of the state and these plans subsequently became defined benefit corporate pension plans, while the multi-employer Employees' Pension Fund plans set up by groups of small businesses belonging to the same industry and such are still in existence.

In general, all the employees of a company who meet the eligibility requirements of a defined contribution corporate pension plan join that plan. This is different from the situation in the US, where employees decide for themselves whether to join a 401(k) plan. However, some companies allow their employees to choose between joining a defined contribution pension plan and receiving their pension equivalent together with their salary or bonus (i.e., while they are still working and without the tax benefits). According to a survey by the Pension Fund Association,[4] 31.4% of the companies that responded said they offered their employees this choice and that 74.2% of employees offered this choice opted to join a defined contribution pension plan.

[4] "Kakutei Kyoshutsu Nenkin ni Kansuru Jittai Chosa (Dai 2kai) Chosa Kekka: Jigyonushi Chosahen" [Findings of (Second) Survey of Defined Contribution Pension Plans: Employer Survey], 20 December 2007.

2. Participation

As of end-March 2008, participants in defined contribution corporate pension plans in Japan numbered 2,711,000. Participants in defined contribution individual pension plans numbered 93,036, of which 37,572 were self-employed persons and 55,464 employees of companies not offering a corporate pension plan. The basic assumption underlying the defined contribution pension system is that employees will join a corporate plan while self-employed persons join an individual plan. However, by way of an exception, employees of companies offering neither a defined benefit nor a defined contribution pension plan are allowed to join a defined contribution individual pension plan. Although this was intended as an exception, more than half the participants in defined contribution individual pension plans are, in fact, employees of companies offering neither a defined benefit nor a defined contribution pension plan.

Approximately 8.0% of all 33,790,000 private-sector employees[5] (i.e., Employees Pension Insurance Scheme participants) belong to defined contribution corporate pension plans. Although this is a reasonable number for a system that has existed only for six-and-a-half years, the corresponding figure for US 401(k) plans in 1987 (i.e., six years after they were introduced in 1981) was 13,130,000 (i.e., 14.3% of all 91,560,000 wage-earning private-sector employees). Participation in Japan's defined contribution pension system is subject to the restrictions listed in Figure 3. We conclude from this that these restrictions will have to be eased if participation is to increase dramatically.

Figure 3: Eligibility and Contribution Limits

Employment status	Eligibility	(Annual) contribution limit
Private-sector employee		
• Employer provides defined contribution plan		
Defined contribution plan only	Eligible to join corporate plan	¥552,000
In combination with defined benefit plan	Eligible to join corporate plan	¥276,000
• Employer does not provide defined contribution plan		
No defined benefit plan	Eligible to join individual plan	¥216,000
Provides defined benefit plan	Ineligible	-
Public-sector employee	Ineligible	-
Unearning spouse of company employee, etc.	Ineligible	-
Self-employed person	Eligible to join individual plan	¥816,000

Source: NICMR.

5 These numbers are as of March 2007. However, we have assumed no significant change.

3. Plan assets and contribution limits

The assets of a defined contribution pension plan are administered by an asset administrator (trust bank or life insurance company). As of March 2007, trust banks were entrusted with ¥2,768,800,000 of defined contribution corporate pension assets.[6] We estimate that, together with the assets entrusted to life insurance companies,[7] the total is about ¥3 trillion.[8]

As of March 2008, the average annual contribution was ¥170,280. In 2004, contribution limits were raised. As a result, the average contribution has increased.

The annual limit is ¥552,000 for companies that have only a defined contribution plan and ¥276,000 for those that also have a defined benefit plan (Figure 3). Over a period of 30 years, for example, this would amount to ¥16,560,000 and ¥8,280,000, respectively. In order to make the most of this tax concession, however, a company would have to contribute the maximum amount every year from the time an employee joined the company.

In most cases, however, contributions are either a fixed percentage of an employee's salary or something similar rather than a fixed amount. According to the above-mentioned survey by the Pension Fund Association, 84.2% of companies pay either a graded amount (according to job category, qualifications or grade) or a fixed percentage. As a result, they often only pay the maximum possible contribution when an employee's salary is at its peak. As salaries generally rise in line with years of service, contributions for employees who are young and therefore still on a low salary will tend to be less than the contribution limit, a portion of which is therefore unused.

4. Investment decisions and investment education

1) Plan administrators and investment products

The main characteristic of defined contribution pension plans is that participants are expected to learn about investment via investment education programs to choose investment products for their own account from the range offered by the plan. Their investment instructions will therefore depend on the range of products on offer and investment education.

Companies often ask plan administrators to select the range of investment products to be offered and to arrange for plan participants to learn about investment. As of end-March 2008, 664 companies were registered as plan administrators. According to Nenkin Joho (the Nikkei's "Newsletter on Pensions & Investment"), however, only 90 or so of these are engaged in plan administration, indicating that most of the business

---

[6] Internet edition of the Nikkei's "Newsletter on Pensions & Investment," 8 August 2007.

[7] ¥385.1bn as of September 2007, according to the Nikkei's "Newsletter on Pensions & Investment," 7 January 2008.

[8] As was mentioned above, 60% of defined contribution corporate pension plans have involved the transfer of assets from other plans. However, we have no data on the amount involved.

is handled by a handful of leading companies.[9] In terms of the number of participants, these are Mizuho Financial Group (i.e., Mizuho Bank and Mizuho Corporate Bank), Defined Contribution Plan Consulting of Japan (DCJ), Nippon Life, Nomura Pension Support & Service (NSAS), Sumitomo Trust and Banking, and Japan Pension Navigator (J-PEC). DCJ is a joint venture by Bank of Tokyo-Mitsubishi UFJ, Mitsubishi UFJ Trust and Banking Corporation, Meiji Yasuda Life, and Tokio Marine & Nichido Fire Insurance; NSAS is a Nomura Group company; while J-PEC is a joint venture by Sumitomo Mitsui Banking Corporation, Sumitomo Life and other members of the Sumitomo Mitsui Financial Group. Each is a major financial services provider or an affiliate of such a company.

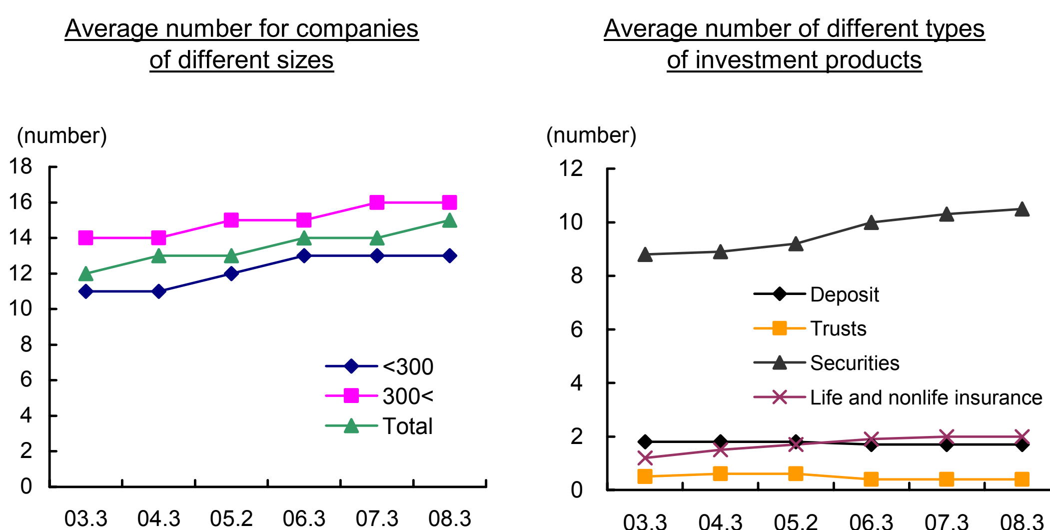
Under the rules governing defined contribution pension plans, the capital of at least one of the investment products offered must be secured. The corresponding savings and insurance products are therefore called "capital-secured products." In addition, participants can choose from a number of investment products involving risk and return, typically investment trusts.

As of March 2008, the average number of investment products offered was 15. The number has gradually increased in the past few years. In terms of product type, the average number investing in securities (e.g., investment trusts) is the highest and is also increasing steadily. The range of investment products appears to have been extended mainly by increasing the number of investment trusts offered (Figure 4).

There is something to be said both for and against the increase in the number of products. While some may see the increase as giving plan participants a wider choice, others may see it as a potential cause of confusion. Whatever the truth of the matter, it is difficult to say what the right number of products would be as a rule. The problem, in our view, is that under the current regulations Japanese defined contribution pension plans can increase the number of their investment products but cannot reduce it. We will have more to say about this later.

[9] According to an article ("Nihonban 401(k) Saishin Jutaku Jisseki, Un'ei Kanri Kikan, Miete Kita 5daiseiryoku: 07nen Zenkoku Chosa" [Latest Data on Japanese 401(k) Pension Plans: 2007 Nationwide Survey]) in the Nikkei's "Newsletter on Pensions & Investment" (20 August 2007), there were 90 companies active as plan administrators. Of these, the top five accounted for more than 60% of plan participants.

Figure 4: Number of Investment Products



Note: "Securities" includes investment trusts.
Source: NICMR from Ministry of Health, Labour and Welfare's Pension Bureau data.

2) Investment education

An analysis of plan participants' actual investment decisions reveals that many opt for capital-secured products. According to a 2007 survey by the Pension Fund Association, 56.82% of participants' assets were invested in capital-secured products compared with 43.18% in investment trusts, while 51.26% of contributions were invested in capital-secured products compared with 48.74% in investment trusts.[10]

Many employers are reported to be concerned by this preference for capital-secured products. While this preference would be unproblematic if the investment decision is made with understanding, many employers are not sure about that and are concerned whether the investment education is satisfactory. The rules governing defined contribution pension plans in Japan require employers to make efforts to provide investment education. While it is now six-and-a-half years since defined contribution pension plans were introduced in Japan and there would appear to be a consensus about what plan participants need to learn when they join a plan and how this should be done, there has recently been some concern about how to provide on-going investment education. It appears that the resources employers can put into this vary considerably, as do participants' interest and understanding. Even in the US, where the importance of on-going education for 401(k) plans (the model for Japanese defined contribution pension plans) was not fully recognized until this century, experience is limited. Japan therefore needs to devise its own solutions to this problem.

Partly with this aim in mind, the Pension Fund Association published an "Investment Education Handbook" for defined contribution pension plan participant

[10] These are the "latest" figures according to the findings of the September 2007 survey, but they do not necessarily represent the situation on the same date.

in March 2008. With an eye to the above-mentioned problems of on-going education for pension plan participants, the handbook divides education contents into two types (one containing some basic but essential issues, the other containing some more advanced practical knowledge) and is aimed at companies wondering what to do about on-going education for plan participants, or companies considering introducing a defined contribution pension plan and wishing to know about investment education in advance.

3) Default investment products

Another problem that has recently attracted attention in connection with investment instructions from plan participants is that of "default products." These are the pre-determined products to which the contributions are automatically allocated in the absence of any instructions from a plan participant.[11] Capital-secured products are stipulated as a default product in general. Recently, however, some plans have begun to stipulate investment trusts.

One reason for this is the unlikeliness of achieving a plan's "assumed rate of return" from deposits. A plan's assumed rate of return is the rate of return on investment a participant must achieve in order to obtain the same retirement benefits as the plan that was replaced by the defined contribution pension plan. According to a survey by the Pension Fund Association, the average assumed rate of return is 2.34%. This is impossible to achieve at current deposit rates, and one could argue that it is more sensible to choose default investment products that historical data suggest are more likely to achieve the assumed rate of return.

However, stipulating an investment trust as the default product risks a loss of capital in the short term. Official guidance for companies to stipulate investment products with risk as default products would make it easier for them to justify this if dissatisfied plan participants took them to court over it.

The response of the MHLW in March 2008 was to lay down the conditions on which a company may stipulate a product with investment risk (i.e., non-capital-secured) as the default product for a defined contribution pension plan.[12] Specifically, employers and plan administrators are obliged (1) to inform plan participants in advance that their contributions will be invested in the default product unless they give instructions to the contrary and (2) to inform them about this product. It will be interesting to see how the Ministry's provisions affect the choice of default products in the months and years to come.

---

11 Whether or not there is a default product depends on which company does the record keeping. There are two major record-keeping companies in Japan: Japan Investor Solutions & Technologies (JIS&T) and Nippon Record Keeping Network (NRK). If JIS&T is the record-keeper, the plan sponsor will stipulate a default product; but, if it is NRK, there will be no default product and all plan participants will have to specify a product.

12 This was included as an amendment to "Standards Governing the Approval of Defined Contribution Pension Plan Agreements," 14 March 2008.

III. Reform Issues

It should be clear from the above that the rules governing defined contribution pension plans in Japan are in need of reform. In this chapter we consider some recent arguments for reform (Figure 5).

Figure 5: Main Issues Facing and Recent Developments Involving Defined Contribution Pension Plans

Issue	Details	Recent developments
Contributions	• Increase contribution limits	• Increased as part of the public pension reforms of 2004, but no significant changes since
	• Allow participants in corporate plans to contribute themselves	• Proposed by MHLW and FSA as part of their tax amendment proposals for FY08 but not included in the Tax Reform Bill for FY08
	• Increase limits on contributions to individual plans for employees of companies with no plans	• Proposed by MHLW and FSA as part of their tax amendment proposals for FY08 but not included in the Tax Reform Bill for FY08
Greater eligibility	• Allow public-sector employees to join	• No developments
	• Allow unearning spouses (Category 3 insured persons) to join	• No developments
	• Allow employees of companies with a defined benefit plan but no defined contribution plan to join an individual plan	• Proposed by MHLW and FSA as part of their tax amendment proposals for FY08 but not included in the Tax Reform Bill for FY08
	• Raise age of participation to 60-plus	• The Employee Pensions Standardization Bill included a provision to allow employees to join up to the age of 65, but the bill has not been passed (currently before the 169th session of the Diet)
Early withdrawal	• Make early withdrawal easier	• The Employee Pensions Standardization Bill included a provision to make this easier, but the bill has not been passed (currently before the 169th session of the Diet)
Automatic transfer	• Deal with 90,000-plus former plan participants whose pension assets have been automatically transferred	• National Pension Fund Association has set up a group to discuss the issue
Special corporation tax	• Abolish such taxation	• A proposal to extend the suspension of the tax for another three years was included in the Tax Reform Bill for FY08, which was passed in April 2008
Investment	• Provide suitable on-going education	• Pension Fund Association has published a "Handbook of Investment Education"
	• Allow investment products to be removed from investment menu (currently requires approval of individual participants)	• The Employee Pensions Standardization Bill included a provision to enable investment products to be removed from the list of approved investments, but the bill has not been passed (currently before the 169th session of the Diet)

Source: NICMR.

1. Arguments surrounding participant contributions to defined contribution corporate pension plans[13]

1) Advantages of participant contributions

Of the various possible reforms to Japan's rules governing defined contribution pensions, the one that attracted the most attention towards the end of last year was whether participants should be allowed to make contributions to corporate plans. In the US, 401(k) plan participants contribute to their companies' plans and the companies may match their contributions. In Japan, however, only companies, not individual participants, are allowed to contribute to defined contribution corporate pension plans even though the system is meant to encourage "self-reliance." There have been calls to reform the system ever since it was created. In 2007, both the MHLW and the FSA called for amendments to the existing system in their tax amendment proposals for FY08, but no such amendments were included in the Tax Reform Bill.

The main advantage of allowing individual participants to make contributions is that it would allow them to make additional contributions of their own free will and to make financial provision for their retirement with tax benefits. Another advantage is that it would encourage participants to take more interest in their pension plan and its investments. Also, while the only way under the existing system for participants to accelerate their pension assets accumulation later in their career is to invest more aggressively, allowing them to make individual contributions would enable them to do so by increasing the contributions.[14]

2) Should participant contributions be within existing limits or in addition to them?

It is an important point whether participant contributions should be within existing limits (¥552,000 or ¥276,000, Figure 4) or in addition to them. As the existing limits can hardly be said to be adequate (see below), we think it would be better if there were separate limits for individual contributions. However, both the MHLW and the FSA have argued that they should be within the existing limits. Although this would be less effective than additional limits, it would be better than not allowing individual contributions at all. As we mentioned in Chapter II, junior employees of companies that contribute either a fixed percentage of their salaries or on a similar basis tend to find that a portion of their contribution limit is left unused. If allowing such employees to make individual contributions used up the rest of their contribution limit, the effect for them would be to virtually increase the limit.

However, the MHLW's proposal was that individual contributions should not exceed company contribution limits. The thinking behind this is that it would be odd if participant contributions were to exceed company contributions in what is supposed

---

13 For further details, see Akiko Nomura, "Kigyogata Kakutei Kyoshutsu Nenkin e no Kojin Kyoshutsu Donyu" [Introduction of Individual Contributions to Defined Contribution Corporate Pension Plans], Kigyo Nenkin [Corporate Pension Plans], October 2007.

14 In the US, plan participants aged 50 or over can pay up to $5,000/year in additional ("catch-up") contributions.

to be a corporate pension plan. Our view, however, is that such a restriction is undesirable in that it would limit the number of plan participants who would benefit from reforms to the system.

Also, if a portion of junior employees' contribution limits was left unused even if they were allowed to make individual contributions, it would surely make sense for them to be able to carry forward the unused amount to later years. As the system is supposed to encourage self-reliance, it would surely make sense for it to enable plan participants to contribute according to their life cycle.

2. Debate about contribution limits, early withdrawal and special corporation tax

1) Thinking behind contribution limits

The contribution limits on defined contribution pension plans were calculated on the basis that, in combination with a public pension, they would provide employees with an income equivalent to 60% of the public-sector employee's pre-retirement earnings ("desirable level"). The 2004 increase in the contribution limits was intended to offset the cut in public pension benefits produced by linking the level of benefits to economic growth and demographics. Thus the increase was consistent with the system's original thinking.

The contribution limit designed to achieve the "desirable level" in combination with a public pension is the "necessary and sufficient" level. However, it might not be a bad idea for the thinking behind the tax-benefit limits to be reasonably flexible. As we mentioned above, contributing a fixed percentage of an employee's salary will not use up the full limit. Rather than saying that the contribution method should be changed to match the contribution limit, it is better to say that the contribution limit is flexible enough (i.e., that it is not assumed to be used up) to permit a wide range of contribution methods. Although it is difficult to compare different countries, companies and plan participants in the US are together allowed to contribute up to $46,000 a year to a participant's 401(k) plan account. At this level of contribution limit companies can devise a pension plan for most of their employees without having to bother too much about tax limits.

2) Restrictions on early withdrawal

Contributions to defined contribution pension plans are eligible for tax relief because such plans are intended to enable their participants to build up assets for their retirement. Because of the need to ensure the integrity of participants' contributions and plan assets, there are tight restrictions on early withdrawal from a plan (i.e., before the age of 60). Under the current rules, plan participants are only allowed to withdraw cash from a defined contribution pension plan before the age of 60 in two circumstances other than death or severe disability: (1) if they do not belong to a corporate pension plan and do not meet the requirements for joining an individual

plan, and have not contributed for a total period of more than 1–36 months or their plan's total assets do not exceed ¥500,000; or 2) if they have left a company and its pension plan and their plan's assets do not exceed ¥15,000.

On the other hand, in Japan it is still very common for employees to receive a lump sum when they leave the company. As we mentioned in Chapter II, many companies have introduced defined contribution pension plans as part of the process of reorganizing their existing retirement plans, including lump-sum payment plans. The fact that defined contribution pension plans do not allow participants to withdraw their plan assets when they leave a company is reported to be one of the main obstacles to their introduction. As companies are free to set up corporate pension plans that best meet the needs of their employees, a situation should be avoided where blind adherence to rules and regulations prevents them from doing this.

One of the amendments included in the Employee Pensions Standardization Bill was to allow former employees to withdraw their assets if they had been an inactive member of individual defined contribution pension plan for two years and their assets did not exceed ¥250,000. Although the proposal was criticized as being too narrow in scope, there is probably no alternative to gradually increasing the number of exceptions so long as a gap remains between theory and practice. A more radical measure would be to allow participants to withdraw funds early on payment of a penalty tax as in the US.

3) Special corporation tax

As we mentioned at the beginning of this report, the only key tax-related amendment that was actually included in the Tax Reform Bill was the continued suspension of the special corporation tax. The special corporation tax is a tax on the investment assets of corporate pension plans, whether they are defined contribution or defined benefit plans.[15] The tax was suspended in 1999, and the suspension was then extended every time before the expiration date. The Tax Reform Bill was finally passed on April 30, 2008 and the suspension of the special corporation tax was applied retroactively so that the fact that the bill was not passed before the end of the FY 07 would not cause any practical problem.

Various parties are proposing to abolish the special corporation tax rather than extend its suspension. Debate on this proposal is likely to involve the issue of how corporate pension plans should be taxed when contributions are made, assets invested and benefits paid. Under the current system, there is a tax concession when participants receive the benefit. If the suspension of the special corporation tax is extended, pension plan participants will enjoy preferential tax treatment at all three stages: when they pay contributions, when their assets are invested, and when they receive their benefits. For those who consider this treatment too generous, any move to abolish tax at the investment stage is likely to set off calls for fully taxing benefit

---

[15] Employees' Pension Fund plans are exempted from special corporation tax until benefits reach the above-mentioned "desirable level."

payments. As abolishing tax concessions on benefits would have major knock-on effects, reaching agreement on how the three stages should be taxed will be difficult. However, there is probably no way of avoiding this issue if there is to be a debate on abolishing the special corporation tax. In the US, there is also a TEE system of taxation for defined contribution pension plans, with tax being levied at the contribution stage but not the investment and benefit stages. It might well be worth considering various approaches, including such an option, in Japan.

3. Eligibility restrictions

1) Debate about extending eligibility

Eligibility of existing defined contribution pension plans is subject to the restrictions listed in Figure 3.

To remedy this situation, in their tax proposals submitted in August 2007 the MHLW and the FSA called for the existing system to be amended so that, when participant contributions to defined contribution corporate plans are allowed, (1) employees of companies with a defined benefit corporate plan but no defined contribution corporate plan can participate in an individual plan and (2) employees of companies with no corporate pension plan can have the limits on contributions to their individual plans increased.

The first proposal is that, for the sake of fairness, employees who are participants only in a defined benefit pension plan should be allowed to make individual contributions by opening an individual plan account if participants in a defined contribution corporate plan are allowed to make individual contributions.

We mention the second proposal (to increase contribution limits) in this context because, like the first proposal, it was made to ensure equal treatment with allowing individual contributions to participants in defined contribution corporate plans. At the moment, employees of companies with no corporate pension plan can participate in a defined contribution individual pension plan, but the contribution limit is the smallest amount (¥216,000/year). According to the MHLW's proposal, participants in a corporate pension plan would be allowed to contribute up to ¥276,000/year (i.e., the company and the participant each contributing half of ¥552,000/year). If this is approved, employees who are currently able to participate in an individual pension plan should have their contribution limit increased from ¥216,000 to the same amount.

These proposals were shelved just like the proposal to allow participant contributions. However, the more eligibility is extended, the more popular the system is likely to become. For example, defined benefit plans vary in detail from company to company. Allowing employees to join defined contribution individual plans of their own accord in order to make financial provision for their retirement is surely in keeping with the aim of encouraging self-reliance. Although there has not been a detailed debate on the subject thus far, we hope that public-sector employees and the

unearning spouses of employees (Category 3 insured persons) will also be given the opportunity to participate in defined contribution pension plans.[16]

2) The negative effects of restricting eligibility

The current restrictions on eligibility also explain why the most has not been made of defined contribution pension plan's portability. Even if someone could take his defined contribution assets with him, he would not be able to continue making contributions after the assets were transferred to an individual pension plan if he did not meet the requirements for eligibility, and his assets would remain "frozen" until the age of 60. Participants such as this who are allowed to give investment instructions but not to contribute are called "investment-only participants."[17] This can hardly be called "portability." However, under the current system, this is the situation in which participants in defined contribution pension plans who move to a company with a defined benefit plan but no defined contribution plan or become Category 3 insured persons find themselves.

Restrictions on eligibility can have unintended consequences. One of these is allowing employees to choose between joining a defined contribution pension plan and receiving their pension equivalent together with their salary or bonus as we described in Chapter II. The reason for providing such an arrangement is the view that, for some employees who are unlikely to remain participants for very long, it makes more sense to receive their pension equivalent together with their salary or bonus because the rules on early withdrawal of defined contribution plan assets are so strict. However, funds paid in this way have no particular tax benefits. Also employees who receive them risk spending them. Extending eligibility to join a defined contribution pension plan so that participants can continue to contribute regularly even if they change jobs or stop working would reduce the risk of young employees opting to receive their pension equivalent and losing the opportunity to build up pension assets with tax concession.

Another restriction has to do with what is called in Japan "automatic transfer." If a participant in a defined contribution corporate pension plan loses his right to be a plan participant when he leaves his job or stops working, unless he arranges for them to be transferred to an individual plan within six months his plan assets will automatically be cashed and transferred to the National Pension Fund Association.[18] As of end-

---

[16] As part of the move to standardize the rules governing employee pensions, it has been decided to abolish the "third tier" of public-sector employee pensions and to replace it with a new system. Defined contribution pension plans have been mentioned as one possible replacement option.

[17] As of August 2007 there were 79,069 investment-only participants in defined contribution individual pension plans in Japan and 85,678 active participants.

[18] Self-employed persons can join the National Pension Fund (defined benefit plan) in order to increase their pension benefit. The National Pension Fund Association is responsible for, amongst other things, managing the Fund's assets. One of the other things for which it has been responsible since the introduction of defined contribution pension plans is checking the eligibility of those applying to join defined contribution individual pension plans.

August 2007, no fewer than 93,786 people had had their pension assets "automatically transferred" in this way. As 85,678 people had participated in individual plans by the same date, we have a situation where the number of former plan participants who have, as it were, given up their pension assets is greater than the number of active participants. As these assets are deposited in transaction accounts once they are automatically transferred, they earn no interest and are gradually depleted as fees are deducted. Furthermore, this automatic transfer period does not count towards participation in a defined contribution pension plan.

A number of reasons are cited why plan participants fail to take any action to avoid automatic transfer (e.g., that the system is complicated and that the small amounts involved give them little incentive). However, we suspect that one of the main reasons is that eligibility to join a defined contribution pension plan is too restricted. Provided plan participants are allowed to continue both to make contributions and to invest their assets even if they change jobs or stop working, we see no reason why so many should lose interest even if the initial amount involved is small.

3) Extending eligibility to the over-60s

Thus far we have considered issues concerning the eligibility of the working generation to join a defined contribution pension plan. However, we think it is also important for the over-60s to be allowed to do this. As no-one aged 60 or over is allowed to become a defined contribution pension participant, those who continue to work as a result of the raising of the retirement age lose their eligibility when becoming age 60. An amendment to allow such participants into remain active participants between the ages of 60 and 65 was included in the Employee Pensions Standardization Bill.

Although this was an important first step, we think there is further scope for extending eligibility to the over-60s. As payment of public pensions does not begin until the age of 65, we think there is a good case for raising the age of eligibility for participants in defined contribution pension plans across the board (i.e., not limiting it to the cases we have described) to 65. Furthermore, we expect the lifestyles of people in their 60s, whether they are planning to retire in the near future or to continue to work for as long as possible, to become increasingly varied. Those who wish to continue to work beyond the age of 65 now have the option of delaying receipt of public pensions up to the age of 70 in exchange for a larger pension later. We think it would be a good idea to allow participants in a defined contribution pension plan to continue to contribute to their plan until the age of 65 or even later while allowing them to draw benefits from the age of 60 if they wish.[19]

[19] In the US, participants in defined contribution plans can receive benefits from the age of 59 years and six months, and make contributions until the age of 70 years and six months.

4. Removing investment products

As we mentioned in Chapter II, once an investment product is included in the list of a defined contribution pension plan's investment products, it is almost impossible to remove it. This is because removing a product requires the consent of each and every plan participant investing in the product, something that is seen as impracticable. Nevertheless, there are a number of reasons why it might be necessary to remove a product. These include long-term underperformance; a change in the product as a result, for example, of a change in the fund manager; and the appearance of similar but better products. The Employee Pensions Standardization Bill therefore included a provision to allow management and employees collectively to remove a product instead of having to obtain the consent of each participant.

If this becomes law, removing an investment product will become a practicable option and the present inconsistent state of affairs, where the number of products can only increase, will be rectified. That said, this should not by any means to cause product selection to be neglected. It is often pointed out that the choice of plan administrator, whose job it is to choose the list of investment products, tends to be influenced by business considerations,[20] and employers should be reminded that they have a duty to ensure that the choice of plan administrator should be made solely in the interests of plan participants.

In the US, it has become increasingly common for 401(k) plan administrators to explain their policy for choosing and monitoring investment products in an "investment policy statement."[21] In Japan defined benefit plans are required to have an investment policy statement. In the case of US 401(k) plans, such a document sometimes includes provisions for removing investment products. Once Japanese defined contribution pension plans are able to remove products from their list of products, procedures such as these should prove instructive.

IV. Changing Conditions

As we pointed out in Chapter III, Japan's system of defined contribution pension plans has many shortcomings and ample scope for improvement. At the same time, Japan's defined benefit pension plans are also facing a number of changes.

---

[20] See "Nihonban 401(k) Saishin Jutaku Jisseki, Un'ei Kanri Kikan, Miete Kita 5daiseiryoku: 07nen Zenkoku Chosa" [Latest Data on Japanese 401(k) Pension Plans: 2007 Nationwide Survey], "Newsletter on Pensions & Investment," 20 August 2007.

[21] According to a 2005 survey of Japanese defined contribution pension plans by the journal "Plan Sponsor," 71.2% of plans published an investment policy statement.

1. Post-retirement benefit accounting in focus again

The introduction of post-retirement benefit accounting in Japan in FY00 led to far-reaching changes in Japanese corporate pension accounting standards. Basically, this brought them into line with both international (IAS19) and US (FAS87) standards. The new system to account for pension liabilities on an accrual basis, as well as the difficult investment conditions prevailing at the time, is said to have been a major cause of the retirement benefit plans revision among many companies. Particular changes included the return of the part of Employees' Pension Fund plans that companies managed on behalf of the state, and the introduction of defined contribution pension plans.

International accounting standards have continued to converge, and in the field of pension accounting the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) agreed in 2004 to work in cooperation (Figure 6).

Figure 6: Recent Developments in Pension Accounting Involving the IASB and the FASB

Date	Issues
April 2004	• IASB and FASB agreed that pension benefits should be the subject of a major joint project and that they should endeavor to draw up internationally convergent accounting standards.
January 2005	• UK's FRS17 accounting standard became effective in full. Main feature is its emphasis on immediate recognition. Under IAS19, companies are allowed to adopt the same "corridor approach" as under FAS87. However, they now have the option of using the FRS17 approach.
November 2005	• The FASB began a pension accounting project. The first phase was to cover balance sheets, the second to cover income statements and other matters.
July 2006	• The IASB began a pension accounting project with a view to adopting revised standards by 2011.
September 2006	• The FASB issued FAS158, amending FAS87 and strengthening immediate recognition of the state of a pension plan's funding in a company's balance sheet. This completed the first phase of its pension accounting project.
August 2007	• The FASB decided the agenda of the second phase: income statement etc. disclosure, multi-employer plan disclosure, and disclosure of the risks inherent in plan assets (e.g., derivatives).
March 2008	• FASB published a staff position on strengthening disclosure of plan assets. • The IASB published a discussion paper on IAS19 and asked for public comment on abolishing deferred recognition.

Note: The "corridor approach" allows a company to assume a range ("corridor") for actuarial gains/losses and to recognize gains/losses that fall outside this corridor in the income statement.

Source: NICMR, from IASB and FASB data.

The main issue with regard to pension accounting has been to promote the acceptance of "immediate recognition." For example, under both IAS19 and FAS87 as well as Japanese post-retirement benefit accounting standards, pension underfunding has been accounted for by an adjustment that entails writing off the shortfall over a number of fiscal years rather than treating it as a liability immediately. Pension reserves are vulnerable to short-term market movements. The adjustment ("deferred recognition") is made in order to avoid an undesirable impact on company financial statements from fiscal year-end market movements when the pension system has not changed in real terms. The opposite is "immediate recognition," where the state of a company's pension reserves is recorded without making any adjustment.

Although a case can be made for using deferred recognition, this approach has been criticized since the 1990s for obscuring the true state of affairs of a pension fund's reserves. In January 2005, the UK's financial reporting standard on pensions (FRS17) was amended to fully incorporate immediate recognition, while, in September 2006, the FASB amended FAS87 and adopted FAS158, thereby making the use of immediate recognition compulsory in the balance sheet treatment of pension reserves.

Moreover, on 27 March 2008, the IASB published a discussion paper on amending IAS19. In the paper the IASB provisionally recommended that deferred recognition be abolished (on the grounds that its use could lead to misleading numbers in financial statements) and invited public comment on the paper by 26 September 2008.

International practice is slowly but surely moving in the direction of immediate recognition. Immediate recognition may have a twofold impact on defined benefit pension plans in that it could encourage companies to shift (1) their pension assets from equities to bonds and (2) from defined benefit to defined contribution plans. The former represents an attempt to reduce changes in pension reserve levels by investing in assets that tend to mirror the reaction of pension liabilities to market movements. The recent interest in liability-driven investment (LDI) also reflects this thinking. The latter is an option for companies that feel that changing their investment policy does not go far enough. Although pension accounting is not the only reason, these shifts have actually occurred in the UK and the US.

These are developments that Japan cannot simply ignore. Following comments by the Committee of European Securities Regulators (CESR), the Accounting Standards Board of Japan (ASBJ) decided to review the discount rate for pension benefit obligations as a short-term measure and published Public Draft of Accounting Standards No. 24 (a third set of draft amendments to the Post-Retirement Benefit Accounting Standards), inviting public comment by 16 May 2008.

Under Japan's current accounting standards for post-retirement benefits, the discount rate is set mainly according to the yield on low-risk long-term bonds. However, when setting the rate, companies are allowed "to take into account fluctuations in the yield over a certain period." Under the proposed amendments, this would no longer be allowed. Abolishing this smoothing mechanism can be seen as a first step towards immediate recognition. The ASBJ has also indicated that it intends

to work on the issue of international convergence of post-retirement benefit accounting in the medium to long term.

Figure 7 gives a breakdown of the number of listed Japanese companies that have introduced defined contribution pension plans. The number is only 26% of the companies listed on the First Section of the Tokyo Stock Exchange and 19% of all listed Japanese companies (i.e., including those listed on the JASDAQ and other venture markets). It remains to be seen what will happen to Japan's post-retirement benefit accounting standards as a result of developments overseas and whether any changes will eventually lead public companies to reconsider their defined benefit pension plans. However, with the situation changing all the time, we would expect the advantages of defined contribution pension plans to increase in relative terms. The regulatory issues surrounding these plans will need to be resolved if they are to become an attractive option for more companies.

Figure 7: State of Japanese Defined Contribution Corporate Plans (as of February 2008)

Market	(A) Number of companies with defined contribution plans	(B) Number of companies listed on market (Note 2)	(A)÷(B)
Tokyo Stock Exchange			
First Section (Note 1)	457	1727	26%
Second Section	52	470	11%
Mothers	10	193	5%
Osaka Securities Exchange			
First Section	6	30	20%
Second Section	29	193	15%
Hercules	14	166	8%
Nagoya Stock Exchange			
First Section	1		14%
Second Section	11	113	
Centrex	3		
Sapporo Stock Exchange	2	25	8%
Fukuoka Stock Exchange	4	40	10%
JASDAQ	140	964	15%
Total	729	3921	19%

Notes: (1) Includes one non-Japanese company.
(2) The figures for companies listed on markets other than the Tokyo Stock Exchange are for the companies listed only on that market.

Source: NICMR, from the Ministry of Health, Labour and Welfare's "Kakutei Kyoshutsu Nenkin Kigyogata Nenkin Shonin Kiyaku Daihyo Kigyo Ichiran" [List of Companies with Approved Defined Contribution Pension Plan Agreements] and published stock exchange data.

2. The "flexibility" of Japanese defined benefit pension plans is put to the test

In the US, defined benefit pension plans have declined in number since the late 1980s for a number of reasons. It remains to be seen whether a similar change will eventually happen in Japan. However, one major difference between the rules governing corporate pension plans in the two countries is the treatment of vested rights.

Under the US Employment Retirement Income Security Act (ERISA), the law governing corporate pension plans, not only retirees but also active participants have a vested (i.e., non-forfeitable) right to pension benefits in accordance with their past service. These benefits may not be reduced. In Japan, on the other hand, employers may under certain circumstances reduce benefits to both plan participants and retirees. They may do this if they are deemed to have no choice (for example, because their business experiences serious difficulties or contributions are expected to increase sharply) and provided at least two-thirds of both plan participants and retirees agree.

While the rights of participants and retirees of US defined benefit pension plans may be better protected than those of their counterparts in Japan, this has also increased the burden of such plans on plan sponsors and contributed to their decline. Some observers therefore see the "flexibility" of the Japanese system as an advantage. In their view, the fact that, in a worst-case scenario, the sponsors of defined benefit pension plans in Japan can reduce benefits has enabled them to survive.

However, a court ruling in October 2007 may have called this "flexibility" into question. The ruling was in a case brought by retirees of NTT's defined benefit pension plan whose benefits were to be cut. In September 2005 NTT requested the MHLW to allow it to amend the terms of its plan in order, amongst other things, to enable it to reduce benefits.[22] However, the MHLW rejected the request on the grounds that circumstances did not warrant it. In May 2006, NTT filed a lawsuit to the Tokyo District Court to overturn the ruling, but the court rejected the claim in October 2007, ruling that the MHLW's decision was justified.

The court justified its ruling on the grounds (1) that the company had booked ¥100bn or so of net profits every year since 2002 and that it could therefore not claim that worsening business conditions left it with no alternative but to reduce the plan's benefits and (2) that the company's annual profits in fiscal 2002–04 and its expected profits in fiscal 2005 more than covered the necessary contributions and that it could therefore not claim that it would be unable to fund the plan because of a sharp rise in contributions.

NTT has appealed to a higher court, and the case has still to be settled. However, whatever the final outcome, we could point out that, if a company wants to offer a defined benefit pension plan with "flexibility" in mind, it should inform participants in advance how "defined" the plan's benefits are and what its basic stance on reducing

[22] NTT was intending to reduce the plan's benefits by replacing it with a cash balance plan. In anticipation of NTT's application to the MHLW to amend the plan agreement, plan beneficiaries filed a lawsuit for an injunction to prevent the application but that suit was dismissed.

benefits is. Only if we take this into account, can we judge the relative advantages and disadvantages of defined contribution pension plans.

V. Conclusion

Why, in the first place, do we need to do more for defined contribution pension plans in Japan?

The answer is that the role of public pensions in providing a retirement income will inevitably decline and that of corporate pension plans increase as the country's birth rate declines and its population's longevity increases. If Japan's defined benefit pension system has problems, these also need to be addressed. However, its defined contribution pension system has more problems, partly because it is a relatively new system.

As we have seen, some 8% of Japanese private-sector employees are participants in defined contribution pension plans. As combined participation in various types of defined benefit pension plans cannot be separated, simply adding them all together (neglecting the overlapping participation) gives a total of 14,180,000 participants. This represents a maximum of some 42% of Japanese private-sector employees.[23] As some employees belong to both defined contribution and defined benefit pension plans, this means that less than half of Japanese private-sector employees belong to one kind of corporate pension plan or another. In order to increase this percentage, we need to have the choice of a defined contribution pension plan as well as a defined benefit plan.

In addition, defined contribution plans tend to encourage employees to change their attitude (namely, to realize the need for self-reliance and the need to acquire basic investment skills). In the US, the limitations of the effectiveness of the investment education provided for 401(k) plan participants have recently been pointed out. However, this criticism refers to the difficulty of following a systematic approach to investment activities over a long period and not the need to acquire basic investment knowledge. The fact is that most Japanese people, far from being able to invest consistently for the long term, do not even appreciate the need for investment and basic investment knowledge. In our view, defined contribution pension plans provide a good opportunity to acquire those understanding and knowledge.

In April 2008, four private-sector members of the Council on Economic and Fiscal Policy made renewed proposals for the reform of Japan's defined contribution pension system. In the press conference that followed the Council meeting, the Minister for Economic and Fiscal Policy, Hiroko Ota, was asked to what extent the government had discussed the proposals for reform of the system that had already been made. In

---

[23] This is the total number of participants in Employees' Pension Fund plans (4,820,000), defined benefit corporate pension plans (4,300,000) and tax-qualified pension plans (5,060,000) as a percentage of the 33,790,000 participants in the Employees' Pension Insurance Scheme as of March 2007.

her reply, the Minister said that, although the matter had been mentioned in the government's Basic Policies, it had not been discussed at any length as it involved tax reform. However, she said that it would be discussed in detail along with other proposals for tax reform.[24]

In short, the proposals for reforming Japan's defined contribution pension system are on the table. All that remains is to decide what its priorities are. Hopefully, it will take action sooner rather than later and avoid a situation where the number of corporate pension plan participants declines once tax-qualified pension plans are abolished in March 2012.

[24] Summary of the press conference that followed the sixth meeting of the Council on Economic and Fiscal Policy, 1 April 2008.