Japan's pension system: Shift toward greater self-reliance is unavoidable

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I. Japan's tri-level pension system

Japan's pension system comprises three layers. Taking as an example a private-sector company's employee, shown in the middle of Figure 1, the first layer is the public pension's basic pension (National Pension Insurance in the case of a self-employed person), which covers everyone. The second layer, covering company employees, is the Employees' Pension Insurance, and the third layer is the corporate pension, provided by corporations for their employees. We provide a more detailed explanation below, but simply put, corporate pensions include both traditional defined benefit (DB) plans as well as defined contribution (DC) plans, which were introduced in 2001. In addition to these, there are the taxable savings by each individual.

It had been expected in principle that the three layers combined would result in people accumulating sufficient wealth for their old age, but the reality has been that a very high percentage of retirees' income has been provided by public pension benefits. This is about to change, however.

II. The role of public pensions is destined to shrink

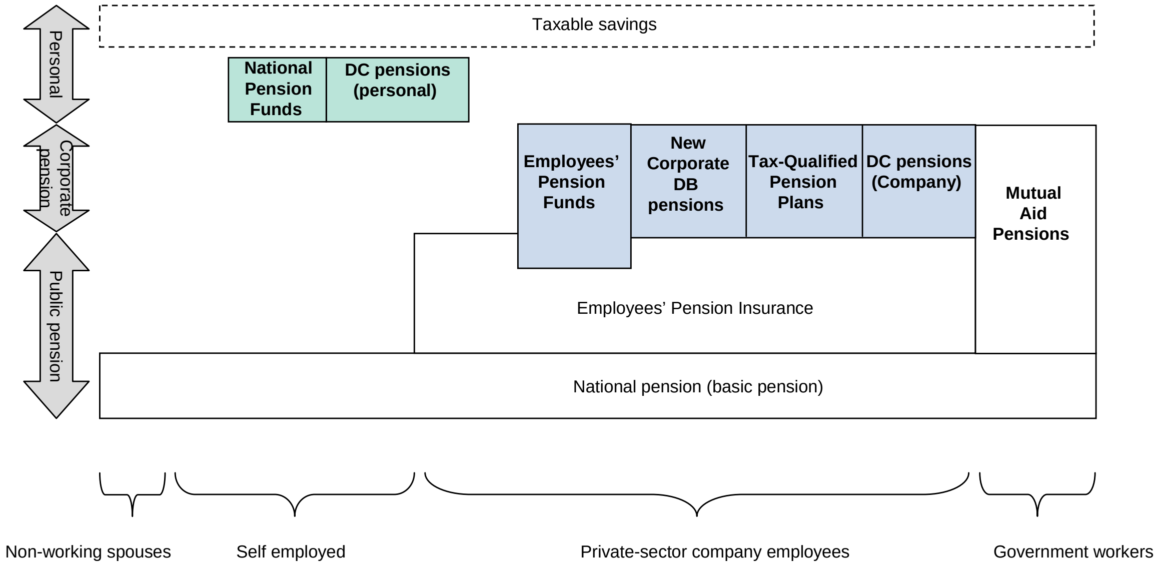
Japan's population has been aging relentlessly, and the public pension, which was based on workers supporting retirees, was expected to place too large of a burden on the currently working generation if it was not modified. This prompted major public pension reform in 2004. The premiums paid by those working are set to be raised incrementally until they reach 18.3%, with employee and employer each paying half. At the same time, a mechanism was added to automatically adjust benefits to accommodate the impact from demographic changes such as declining fertility rates. In other words, the reforms put a cap on the burden on workers, while gradually shrinking public pension benefits.

Debate over public pensions has heated up recently[1], and points to the possibility of another round of drastic reforms in the near future. One thing that can be said for

1 See Akiko Nomura, "Key Issues Regarding Japan's Public Pension Reform," Capital Market Review, Summer 2009.

sure is that public pensions will start playing less of a role in Japan's aging society. This means that corporate pensions and personal retirement savings will have to play a greater role. Corporate pensions offer a large number of people an opportunity at their workplace to build wealth for their retirement years. Compared with people acting individually, this has several advantages, including greater bargaining power with the financial service providers who manage the pension assets. Corporate pensions should become an increasingly important component of Japan's pension system.

Figure1: Overview of pensions in Japan



Source: Nomura Institute of Capital Markets Research

Figure2: Recent reforms of the corporate pension system

March2001	■ Introduction of retirement benefit accounting • Many companies revise their pension schemes
June 2001	■ Defined Contribution Pension Law and Defined Benefit Corporate Pension Law passed • DC plans, a new type of pension, are introduced • *Daiko henjo* allowed. Decision made to abolish TQPP
October 2001	■ Company DC plans launched
January 2002	■ Personal DC plans launched
April 2002	■ *Daiko henjo* started • Shift into New DB plans ■ Shift out of TQPP begins • Shift into New DB plans and DC plans
2009 (currently)	■ Still shifting out of TQPP
March 2012	■ TQPP scheduled to be abolished

Source: Nomura Institute of Capital Markets Research

III. The transformation of DB plans

Major changes were made to the regulations affecting Japan's corporate pensions in 2001 (Figure 2), namely through passage of the Defined Contribution Pension Law and the Defined Benefit Corporate Pension Law.

There had previously been two types of corporate pensions in Japan, both being of the defined benefit type: Employees' Pension Funds (EPFs) and Tax-Qualified Pension Plans (TQPPs). With the new legislation, Defined Benefit Corporate Pensions (New DBs) were added to the mix. One unique aspect of EPFs is that they partly replace the public pension (the Employees' Pension Insurance), but because of the poor investment environment in the 1990s, this replacement was seen to be too great of a burden by corporations. Corporations increasingly sought to return this obligation back to the government, and this became possible in April 2002 with the enactment of the Defined Benefit Corporate Pension Law. As a growing number of corporations returned their portion of the pensions to the government (called *daiko henjo*), the total number of EPFs wound up declining, from a peak of 1883 to only 613 in June 2009. In many of these cases, the corporations shifted the remainder of the EPFs to a New DB plan.

Because Japan's corporate pensions originally derived from a lump sum retirement payout, these plans had two major types of benefits, lump sum payouts and fixed-term annuities. This is in contrast to the United States and countries in Europe, where defined benefit pensions are basically lifetime annuities. That said, the EPF was required to provide a lifetime annuity, because it was paid on behalf of the public pension. The decline in EPFs and shift to New DB plans has likely resulted in a steady decline in the number of DB plans that pay lifetime benefits.

Both the EPFs and New DB plans have been allowed to convert to cash balance plans since April 2002. In a cash balance plan, the virtual individual accounts of participants are credited with both a contribution credit (e.g., a set percentage of their salary) and an interest credit (which is typically linked with JGB yields), and the cumulative totals become the base for pension benefits. Although the company bears the investment risk, pension benefits change in response to fluctuations in market interest rates. It is essentially a defined benefit plan with defined contribution plan features. Cash balance plans have steadily become more popular since they were introduced.

Another critical regulatory reform made in 2001 was the phasing out of TQPPs. which are corporate pensions that receive favorable tax treatment based on their fulfilling certain requirements under the corporate tax law, including the segregation of pension assets from company assets. TQPPs are less tightly regulated than EPFs, and popular among smaller firms. Because of their inadequate protection of participants' right to receive benefits, however, the decision was made to eliminate them, after a 10-year grace period, in March 2012. Rollovers into other retirement plans, including New DB plans and DC pensions, have been encouraged, but with less than three years to go before TQPPs are eliminated, in many cases the plans are just being cashed out instead of being rolled over into a different plan. The concern is that this will ultimately result in a decline in corporate pensions' overall coverage.

March 2001 also marked the application of pension benefit accounting standards. As a part of global accounting standards convergence, pension benefit obligations and expenses started being calculated on an accrual basis, and recognized on the balance sheets of the companies sponsoring the plans. This change in accounting standards coincided with a period of poor investment returns, and ended up providing an incentive for companies to introduce the DC plans explained below. The global trend in pension accounting since then has been toward immediate recognition of the impact on pension funding from changes in stock prices and interest rates, and this may make DB plans seem even more costly to corporations.

IV. The introduction and spread of defined contribution pension plans

Thus DB plans are still around, albeit having effectively been transformed, while DC plans are a new form of corporate pensions that were introduced in 2001. There are two types of DC plans: corporate DC plans offered by companies to their employees, and personal DC plans for the self employed and employees of companies without a corporate pension (neither DB nor DC). An individual can only participate in one of these at a time, unlike in the US, where it is possible to participate in a 401(k) plan while also owning an IRA. As of March 2009, there were 3.11 million persons participating in corporate plans offered by 11,706 companies, and approximately 100,000 persons participating in a personal plan.

A unique feature of DC plans is that the participants choose how to invest the assets in their individual account from a predetermined menu of investment products. The amount of each person's pension benefit is determined by the performance of their investments. Because it is the participants that bear the investment risk, these are also known as "self-reliant" or “self-responsible” pensions. Nevertheless, as evidenced by the fact that over half of the individual financial assets in Japan are in deposits, most Japanese are not accustomed to investing their assets in products such as mutual funds. Thus, corporations are obligated to make an effort to provide investment education to participants, including basic knowledge of investing and of the DC pension scheme, as well as an explanation of the investment products offered within the plan.

There are several features worth noting in regards to how DC plans are managed in Japan. To begin with, the menu of investment products must include at least one product that falls into the “secured principal” category. Bank deposits and insurance products (GICs) are usually the products in this category that are offered. In addition to these, a number of mutual funds that invest in equities (domestic and/or foreign) and bonds (domestic and/or foreign) are also offered, and on average these plans have about 15 products to choose from.

In aggregate, the asset allocation of DC plans in Japan is about 40% deposits, 20% insurance products, and 40% mutual funds, which means that 60% of assets are held in products with secured principal. This is a low-risk, low-return investment allocation. Such an allocation is fine if participants fully understand this when making investments, but the concern is that many participants are keeping their funds in deposits purely because they are unfamiliar with mutual funds. Another possibility is that participants do not give investment instructions because they do not understand what DC plans are about, and that because of that the funds are put into bank deposits, which are often the default investment product (the product that is purchased if the participant does not instruct otherwise).

Another feature is the presence of an "assumed rate of return." In many cases, DC plans were introduced as part of the process of remaking existing retirement benefit programs. Typically, DC plans were offered by companies either as a replacement for lump-sum retirement payouts, as a response to the abolishment of the TQPP that they had been offering, or as part of the *daiko henjo* process of returning their portion of the EPF to the government. In these situations, a certain rate of return was often assumed in order to calculate the contributions necessary to achieve the same level of benefit (expressed as a lump-sum payment) that the participant would have received under the old system. This is the assumed rate of return. In other words, a participant who achieved the assumed rate of return over the long run would receive an amount of benefits from the DC plan that was equivalent to the level of benefits under the previous retirement plan. This assumed rate of return averaged over 2%, however, which is much greater than the investment yield currently obtainable on a product with secured principal. Another area of concern is whether this fact is understood by participants who are investing their funds in secured principal products.

Given this investment reality, and in light of the poor investment environment of late, there has also been a tendency for critics to note how difficult it is for participants to do their own investing. There is still room to improve investment approaches, however, and the first step should be to look closely at potential methods by referencing existing investment services and the experiences of countries like the US that have a longer history with DC plans. For example, for participants who after receiving investment education would rather entrust such decisions as asset allocation and portfolio rebalancing to a professional, one conceivable approach would be to aggressively use target-risk funds, target-date funds, and similar type funds. Another approach worth trying for participants who have an interest in investing but cannot make all of their own decisions would be to use investment advisory services, which can recommend specific investment products and allocations. If any specific regulatory provisions were needed to accommodate these approaches, the regulations should be revised accordingly.

V. Promoting greater participation in DC plans

We see the need for a number of other regulatory changes to DC plans that are unrelated to investment per se. A classic example of this is that although these are considered self-reliant plans, only the company is allowed to contribute, and contributions from participants are not allowed. A bill to revise the Defined Contribution Pension Law that would allow participant contributions was submitted to the Diet in March 2009, but it had not been passed as of June 2009. Another major problem is that eligibility for DC plans is very limited. Employees of companies that offer a DB plan but not a DC plan are not eligible to participate in a personal DC plan. Government employees and spouses of employees without their own income are also ineligible. Consequently, if a participant in a corporate DC plan changes jobs and starts working for a company that only has a DB plan, although they will be able to transfer the assets in their corporate DC plan to a personal DC plan account and continue managing those assets, they will not be able to continue making contributions to that account. This makes it impossible to fully benefit from portability, one of the advantages of a DC plan. Other problems include the low contribution limits and the extremely strict rules governing early withdrawals.

The truth is that the time when people could depend on another entity [the government or the company] to take care of their income after retirement is coming to an end, and thus it is better for individuals to recognize that truth and start building wealth for their own retirement years. DC plans are well suited for that purpose, and we think the problems noted above should be dealt with in order to encourage greater participation in those plans.