The Introduction of Employee Contributions to Defined Contribution Pension Plans

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I. Enactment of *Amendments to Pension Law*

On 4 August 2011 *Amendments to Pension Laws to Support Securing Pension Benefits*[1], legislation permitting employees to make contributions to corporate defined contribution pension plans, was enacted. As this resolved one of the longstanding issues surrounding defined contribution pension plans in Japan, it is highly significant.

Although the legislation was passed by a plenary session of the House of Representatives (lower house) on 18 November 2010, there was no time for debate in the House of Councillors (upper house) as the end of the session arrived. As a compromise on the controversial aspects of the bill was reached when it still being debated by the House of Representatives, it was expected to be passed more or less automatically as soon as the House of Councillors began to debate it. However, it was only on 28 July 2011 that it was finally passed by the House of Councillors' Committee on Health, Labour and Welfare before being passed by a plenary session of the House of Councillors the following day. As the implementation dates of some of the bill's provisions were changed as a result, the bill was sent back to the House of Representatives, where it was passed after another vote.

Until now only employers have been allowed to contribute to Japanese corporate defined contribution pension plans. This state of affairs, where, in spite of the fact that plans were intended to encourage people to make their own provision for their old age and to take responsibility for their own pensions, participants have been allowed to take responsibility for managing their plan assets but not for making their own contributions, can hardly be described as satisfactory.

The new legislation allows them, finally, to do this. Employee contributions are tax-exempt but subject to two restrictions on their amount. The first is that, together, employer and employee contributions may not exceed the statutory limits. There are different limits on how much can be paid into individual defined contribution plan accounts depending on what types of pension plan a company provides. If a company provides only a defined contribution pension plan, the monthly limit on contributions

1 *"Amendments to Pension Laws to Enable Participants in the National Pension System and Corporate Pension Schemes to Provide for Their Old Age."*

is ¥51,000. If it provides both a defined benefit and a defined contribution plan, the limit is ¥25,500 per account per month. Thus, if the monthly limit is, for example, ¥51,000 and the employer contributes ¥40,000, the limit on employee contributions is ¥11,000 (¥51,000 – ¥40,000 = ¥11,000).

The second restriction is that employee contributions may not exceed an employer’s contributions. If a company whose monthly employer contributions are capped at ¥51,000 contributes only ¥10,000, the difference between actual and statutorily permissible contributions is ¥41,000 a month. However, employees are only allowed to make a contribution of up to ¥10,000—not up to ¥41,000.

In addition to allowing employee contributions, the new legislation raises the age limit for participation in corporate defined contribution pension plans from the current limit of 60 to 65, thereby allowing employees to continue to participate in such plans even when they pass the age of 60 if the company provides for their participation. Furthermore, it allows employees with unpaid contributions to the National Pension System to pay up to 10 years’ worth of such contributions retroactively as well as making a number of changes to corporate defined benefit pension plans (Figure 1).

Figure 1: Main provisions of *Amendments to Pension Laws to Support Securing Pension Benefits*

	Main provisions	Implementation date
Amendments to the *Defined Contribution Pension Law*	・Enable employees to make contributions to corporate defined contribution pension plans. ・Increase the age until which employees are eligible to participate in a plan (from 60 to 65), depending on what companies provide. ・Clarify employers' responsibility to provide continuing investor education for plan participants. ・Give pension plans easier access to plan participants' addresses via the Basic Residents' Registration Network, enabling them to contact anyone who has failed to claim benefits to which he or she is entitled from a corporate pension plan.	1 January 2012 The date stipulated by government decree and not later than 30 months after the promulgation date 1 January 2012 Promulgation date
Amendments to the *National Pension Insurance Law*	・Increase the amount of unpaid contributions to the National Pension System that may be paid retroactively from two to 10 years' worth. Enable those who wish to pay such contributions to receive more pension benefits in later years. The window of opportunity to do this is limited to three years after the implementation date. ・Those aged between 60 and 65 (i.e., above the normal age limit of 60) may opt to pay contributions to the National Pension System.	The date stipulated by government decree and not later than 1 October 2012 The date stipulated by government decree and not later than 24 months after the promulgation date
Amendments to the *Employees' Pension Insurance Law*	・Special arrangements apply to the amount and method of payment of the costs incurred in repaying to the state the state earnings-related element of Employees' Pension Insurance funds that have been wound up.	Promulgation date
Amendments to the *Defined Benefit Corporate Pension Law*	・Employees who retire between the age of 60 and 65 will also be eligible to receive a pension when they retire.	Promulgation date

Source: Nomura Institute of Capital Markets Research, based on a summary of the *Amendments to Pension Laws to Support Securing Pension Benefits*

II. The significance of the introduction of employee contributions

1. A valuable tax benefit

The most immediate significance of the introduction of employee contributions is that plan participants have the opportunity to save for their old age while receiving favorable tax treatment. At a time of fiscal austerity when the authorities are scrutinizing tax benefits, this is a truly valuable tax opportunity.

However, if corporate defined contribution pension plan participants are to have this opportunity, companies need to amend their plans to allow employee contributions. Whether or not employees have the opportunity to make contributions makes a decisive difference to their ability to accumulate assets by means of a defined contribution pension plan. As we will see later in this report, companies urgently need to amend their plans in order to give their employees the opportunity to make their own provision for their old age.

2. Raising employee interest in defined contribution pension plans

Until now participants in defined contribution pension plans did not need to pay much attention to their company's contributions to their plans. As a result, many may not have felt that this was their own money. Now that they will be able to make their own contributions out of their pay packets, they are likely to take the issue of providing for their old age more seriously. The introduction of employee contributions can also be seen as an excellent opportunity to give employees some investor education. In turn, we would expect this to increase their interest in defined contribution pension plans considerably.

If plan participants develop a greater sense of responsibility for their plans, they are also likely to adopt a different attitude to managing their plan assets. As well as taking more interest in and developing a greater understanding of investment, they are less likely to leave their money invested in low-risk assets and to forget about it.

3. A boost to the defined contribution pension plan system as a whole

As a direct consequence of employee contributions the amounts contributed, and therefore plan balances, are likely to increase. As a result, some of those companies that have either already introduced defined contribution pension plans or are planning to do so are likely to assign a more important role to such plans in their retirement benefit schemes. As plan participants become more interested in how their assets are invested, some companies may decide to increase the range of investment products available.

As the number of companies offering defined contribution pension plans and the balances of those plans increase, financial service companies offering financial products and services to the employees of those companies are likely to offer increasingly sophisticated products and services. This, in turn, could form a virtuous cycle where an increasing number of companies offer increasingly sophisticated defined contribution pension plans, thereby boosting such plans in general.

III. Outlook

1. Companies should urgently consider allowing employees to make contributions

The provision to allow employees to make contributions comes into effect on 1 January 2012. We think that companies, especially those that attach a high degree of importance to their personnel systems and retirement benefit schemes, will be busy preparing for this and that this should be an urgent priority.

It remains to be seen what percentage of companies will allow their employees to make contributions. However, we have heard that plan administrators have already begun discussing this with their main corporate clients. Let us assume, for argument's sake, that some 10% of plan participants are allowed to make contributions in the first wave of companies to permit this in 2012. As it is by no means certain that every such plan participant will immediately take advantage of this opportunity, let us assume that 50% of these actually do so. In FY09 annual contributions to corporate defined contribution pension plans totaled ¥406.7 billion, an average of ¥125,000 per participant. Assuming that 5% (i.e., 10% × 50%) of plan participants make a corresponding amount of contributions in 2012 (i.e., roughly ¥10,000/month), we estimate that the premiums from this first wave alone would boost annual contributions by about ¥23.1 billion[2].

As it is difficult to imagine that the percentage of participants making contributions would remain at 5%, this estimate should be regarded simply as a hypothesis for the initial period. For example, we can imagine a situation where, in a particular sector, all the companies in the sector decide to allow their employees to make contributions after some of the leading companies in the sector decide to do so. We can also envisage a situation where, once a certain number of companies decide to introduce employee contributions, those that have yet to do so are asked by their employees to explain why. Similarly, we can envisage a situation where the majority of companies introducing a defined contribution pension plan from 2012 onwards allow their employees to make contributions from the very beginning. If this starts a

2 Contribution data from Japan Association of DC Plan Administrators. According to Ministry ofHealth, Labour and Welfare data, plan membership as of March 2011 totaled 3,713,000. We have no specific reason for assuming that 10% of plan participants (i.e., 370,000) will be able to make employee contributions. However, if we assume that large companies with an average workforce of 10,000 employees take the lead, 370,000 plan participants would be equivalent to 37 companies. Our assumption that 50% of those participants would actually avail themselves of the opportunity to make contributions was inferred from the percentage of employees that were members of Japanese employee share ownership plans as of FY09 (45%).

virtuous cycle, employee contributions may eventually become the norm for defined contribution pension plans. If 70% of all plan participants are allowed to make contributions and 70% of these avail themselves of the opportunity[3], the result will be that roughly 50% of all plan participants make contributions. Annual contributions would increase by some 50%.

2. System requires further amendments

While the introduction of employee contributions is a significant development, it does not go far enough. As we have seen, there are two restrictions on contributions that urgently need to be rectified.

First of all, the one limiting the amount of employees' contributions to that of their employers' contributions should be abolished as it means that employees whose employer makes large contributions have more scope to make their own provision for their old age than those whose employer makes small contributions. In fact, it actually increases the disparity in the tax benefits for which employees are eligible. Second, a way needs to be found to increase the amount participants may contribute to their plans. Even if the introduction of employee contributions creates more opportunities for defined contribution pension plan participants to contribute to their plans, it does nothing to alter the fact that contribution limits are still low.

Nor does it alter the fact that defined contribution pension plans have a number of other shortcomings besides those related to contributions. We hope that these amendments will serve to speed up the process of revamping Japan's defined contribution pension system.

[3] The percentage of US companies making matching contributions to corporate defined contribution pension plans was 76.6%, according to a 2010 survey by the US magazine PLANSPONSOR, as in the US it is employers that match contributions. The percentage of employees that are plan participants was 71.5%, according to the same survey, as in the US its is employees who decide whether to join a plan. We think it is possible to reinterpret the former figure as the percentage of companies that introduce features of a plan that are to the benefit of their employees, and the latter figure as the percentage of employees that actually avail themselves of these features.