The Outlook for the Defined Contribution Pension Market in Japan

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I. Introduction

In Japan there are two types of defined contribution pension plan: company plans, which employers have been able to set up on behalf of their employees since October 2001, and individual plans, which self-employed persons and employees whose employers do not offer a company pension plan have been able to join since April 2002. As of May 2006, membership of both types of plan totaled 1,995,000 (Figure 1). Of the two, company plans have made more headway, with assets (as of March 2005) of ¥1,131.8bn, compared with only ¥50.4bn for individual plans.[1]

This report considers the prospects for defined contribution pension plans in Japan, where they were introduced to give people a wider range of options for making financial provision for their retirement, by making a number of assumptions in order to estimate their likely growth in terms of both membership and asset amount. Since the greatest impact on the market for defined contribution pensions is likely to result from transfers from tax-qualified pension plans, which are due to be abolished in March 2012, we will try to forecast the likely membership and asset amount of defined contribution pension plans at that point in time.

At the same time, we will try to allow for the effect of a number of reforms to the existing defined contribution pension system that have been called for for some time, assuming that they are implemented. All our projections are basic and are only intended to give a rough idea of the prospects for the defined contribution pension market in Japan.

Figure 1 Membership of Defined Contribution Pension Plans

・Number of company pension agreements and employers	
Number of approved agreements	1,936
Number of employers	6,930
・Membership	1,995,371
Company plans	1,930,000
Individual plans	65,371
Category 1 members	28,790
Category 2 members	36,581
・Registered plan administrators	681

Note: Membership is as of April 2006.
Source: Ministry of Health, Labour and Welfare.

[1] The figure for the net asset value of individual plans includes the assets of plans whose holders decide how the assets are invested but cannot themselves contribute.

II. The Impact of Transfers from Tax-Qualified Pension Plans

1. The abolition of tax-qualified pension plans in March 2012

One of the main types of defined benefit pension plans in Japan, tax-qualified pension plans numbered more than 90,000 at their peak. However, since the Defined Benefit Corporate Pension Law came into effect in April 2002, they have been due to be abolished in March 2012. As a result, companies that have set up such plans have until then to decide whether to wind up their pension plans altogether or replace them with another type of plan. The most frequently suggested replacement options are defined benefit pension plans, smaller enterprise retirement allowance mutual aid plans, or defined contribution plans.[2]

The membership of tax-qualified pension plans as of March 2006 totaled 5,670,000. Since the membership of defined contribution company pension plans as of May 2006 totaled 1,930,000, what percentage of participants in tax-qualified pension plans transfer to defined contribution pension plans is clearly critical for the growth of the defined contribution pension market.

2. Defining the base case

As a basis for the assumptions that we will make about the growth of the defined contribution pension market in Japan, we will define a base case that makes no assumptions about transfers from tax-qualified pension plans.

The assumptions underlying our base case are listed in Figure 2. However, the main ones are as follows:

(1) The number of participants continues to increase by the same number as the average increase in fiscal 2004 and 2005.

(2) The asset amount does not reflect unrealized capital gains or losses. In other words, it equals total contributions.

(3) Per capita contributions continue to grow by the same amount as the average for fiscal 2004.[3]

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2 Less costly to set up than Employees' Pension Funds, tax-qualified pension plans were relatively common among small businesses. However, they were criticized for a number of shortcomings, including a failure to ensure fiduciary responsibility standards . The Defined Benefit Corporate Pension Law, which came into effect in April 2002, allowed companies to divest themselves of the responsibility for managing part of the Employees' Pension Insurance, the earnings-related portion of the pubic pension. It introduced defined benefit corporate pension plans as a vehicle to which the truly private pension assets could be transferred, while tax-qualified pension plans were to be phased out. The Law contains provisions governing fiduciary responsibilities such as duty of loyalty and duty of care. Smaller enterprise retirement allowance mutual aid plans are administered by the Organization Workers Retirement Allowance Mutual Aid Association on behalf of small businesses with less than a certain number of employees and a certain capitalization.

3 The figure for the average contribution for fiscal 2004 is based on handouts from the 14th Meeting of the Japan Defined Contribution Pension Liaison Conference on 25 November 2005.

(4) Although defined contribution pension plans are often set up to replace existing retirement plans and therefore involve a transfer of assets, we will ignore this. In other words, an increase in contributions resulting from an increase in membership equals the increase in assets.

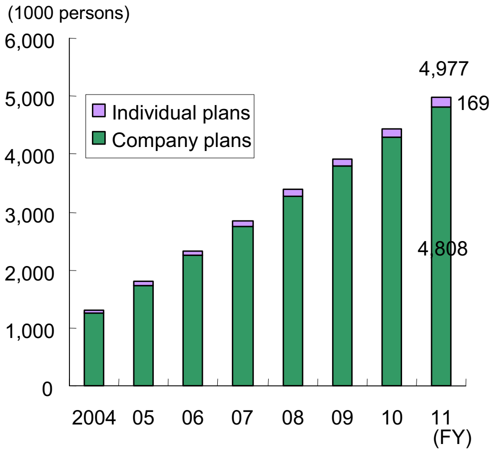
On the basis of these assumptions, we calculate that the membership of defined contribution pension plans in March 2012 will total 4,977,000, of whom 4,808,000 will belong to company plans and 169,000 to individual plans. Similarly, we calculate that the asset amount of these plans will be ¥5,237.2bn, of which ¥4,994.9bn will be the asset amount of company plans and ¥242.4bn that of individual plans (Figure 2).

Figure 2 Base Case Assumptions

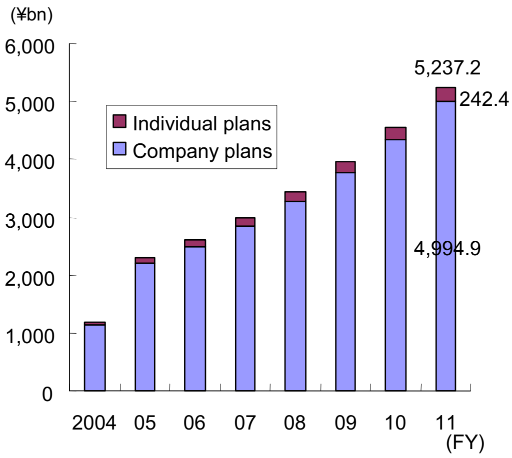
Assumptions

- Membership
  - Membership continues to increase by the same number as the average increase in fiscal 2004 and 2005
    - 513,000 in the case of company plans and 18,000 in the case of individual plans
- Assets
  - Assets as of March 2006 was ¥2.2trn in the case of company plans and ¥110.0bn in the case of individual plans
    - Based on the fact that as of March 2006 trust banks held ¥2trn of company plan assets and ¥109.8bn of individual plan assets (according to "Nenkin Joho," 5 June 2006)
  - Contributions remain the same as the average per capita contribution for fiscal 2004
    - Company plans: ¥11,869/month, ¥142,428/year
    - Individual plans: ¥15,876/month, ¥190,512/year
  - Annual contributions = average per capita contribution for fiscal 2004 x average membership during period
  - Transfers from other schemes are disregarded
  - Unrealized capital gains and losses are disregarded

Membership



Assets



Source: NICMR.

3. Transfers from tax-qualified pension plans

We then add to this base case the likely impact of transfers from tax-qualified pension plans. In doing so, we need to remember two points. First, when we calculated our base case membership, we assumed that membership would increase by the same number as the average for the past two years. However, we need to remember that at least some of the increase has been the result of transfers from tax-qualified pension plans and that our results do not take this fully into account. What this means is that, when we estimate the increase in membership resulting from these transfers and add this number to that of our base case, we are, in fact, double-counting. We should therefore deduct this number from our base case membership. However, as this number is very difficult to estimate, our membership figures are unadjusted for this double counting.

The second point we need to remember is that our base case figures for the asset amount do not include any amounts for assets transferred from other types of pension plan. Although there are no publicly available figures on asset transfers from other types of pension plan, we can safely assume that the total figure is not zero. That means that our base case figure for assets is an underestimate. Moreover, more than 70% of companies that have transferred assets from other types of pension plan have transferred them from either tax-qualified pension plans or a combination of tax-qualified pension plans and other types of pension plan.[4] We have therefore assumed that, by adding to the base case the assets that have been transferred from tax-qualified pension plans and the contributions that can be expected from new participants who transfer from tax-qualified pension plans when this type of pension plan is abolished, we can roughly calculate the amount of assets transferred from other types of pension plan.

Our assumptions are listed in Figure 3. The main ones are the percentage of participants in tax-qualified pension plans who can be expected to transfer to defined contribution pension plans and the amount of assets transferred from tax-qualified pension plans. As far as the first assumption is concerned, we took the finding of a survey (that roughly 40% of companies that have transferred their pension assets from tax-qualified pension plans have transferred them to defined contribution pension plans)[5] and reinterpreted this as 40% of the participants in these plans. As far as the second assumption is concerned, we took the fact that the average per capita asset value of tax-qualified pension plans as of March 2005 was ¥2.796mn and assumed that roughly half of this amount (¥1.5mn) would be transferred to defined contribution pension plans.

On the basis of these assumptions we calculated that the membership of company pension plans as of March 2012 would be 7,076,000. Similarly, we calculated that the assets of these plans would be ¥9,365.9bn (Figure 3). The impact on the asset amount

4 "Kakutei Kyoshutsu Nenkin no Shiko Jokyo" [The Current State of Defined Contribution Pensions], Ministry of Health, Labour and Welfare, end-May 2004.

5 "2005nenban Taishokukin/Nenkin Jijo" [2005 Report on Retirement Allowances and Pensions], Institute of Labor Administration.

of defined contribution pension plans of asset transfers from tax-qualified pension plans can also be seen clearly in the asset value chart.

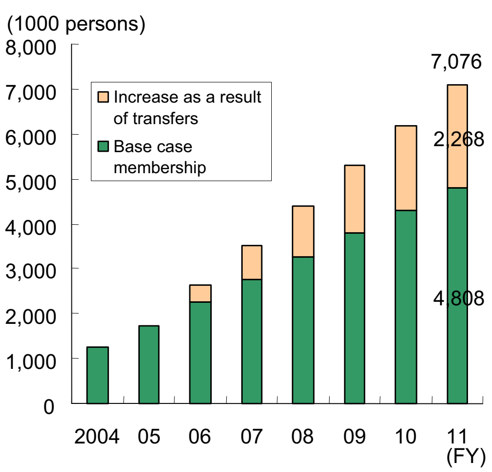
Assuming that the impact on individual plans of the abolition of tax-qualified pension plans would be zero, we calculated that the total membership of company and individual plans in March 2012 would be 7,245,000 and the total assets ¥9,608.3bn. By way of comparison, the total assets of all types of defined benefit plans as of March 2005 were ¥81.4trn.

Figure 3 The Effect of Transfers from Tax-qualified Pension Plans

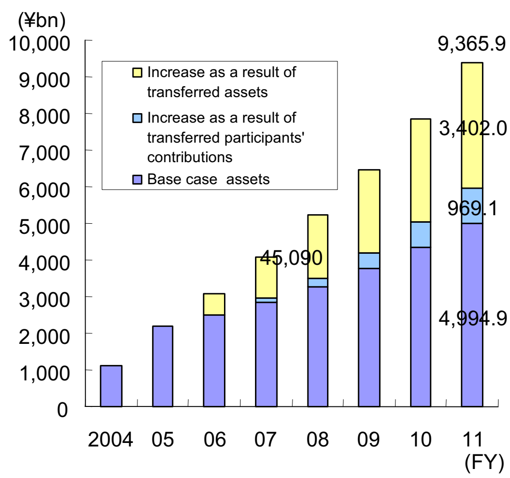
Assumptions

- Tax-qualified pension plans are phased out over six years (fiscal 2006-2011) by equal amounts each year
  - 45,090 pension agreements and 5,670,000 participants as of March 2006
  - Each year 7,515 agreements are terminated and 945,000 participants transfer to other schemes
- 40% of participants transfer to defined contribution company plans
  - According to a survey by the Institute of Labor Administration ("2005nenban Taishokukin Nenkin Jijo"), 39.1% of the schemes that will replace tax qualified pension plans will be defined contribution company plans
  - Each year over six years (fiscal 2006-2011) 378,000 members transfer to company plans
- Contributions
  - Contributions remain the same as the average per capita contribution for fiscal 2004
    - ¥11,869/month, ¥142,428/year
  - Annual contributions = average per capita contribution to defined contribution company plans not offered in combination with defined benefit plans for fiscal 2004 x average membership during period
- Average per capita transfer of assets from tax qualified pension plans is ¥1.5mn
  - This is roughly half the average per capita asset value as of March 2005 (¥2,796,000)

Membership of company plans



Assets of company plans



Source: NICMR.

III. The Problems of Defined Contribution Pension Plans and the Impact of the Reforms to the System

1. The problems of defined contribution pension plans[6]

The main problems of defined contribution pension plans in Japan are listed in Figure 4. There are a number of legal provisions that have impeded the spread of defined contribution pension plans in Japan. For example, (1) employees of companies that have not introduced their own defined contribution pension plans (company plans) cannot join a defined contribution pension plan (individual plan) if they are eligible to join a defined benefit pension plan. (2) Public service workers and spouses with no income of their own (Category 3 insured persons[7]) cannot join, either.

Similarly, employees eligible to join a company pension plan are not allowed to contribute to their own account even though such plans are supposed to encourage participants to be self-reliant. Although the annual limit on contributions was increased following the reforms of 2004, it is still only ¥552,000 at maximum—considerably less than the corresponding figure in the United States ($44,000, or roughly ¥5mn, as of 2006), as has often been pointed out.

In the rest of this section we will consider the likely impact of changing the legal provisions to allow (1) contribution limits to be increased, (2) public service workers and (3) spouses with no income of their own to join a defined contribution pension plan, and (4) employees who are participants in a company pension plan to contribute to their own account. We have therefore calculated the extent to which the membership and asset amount of defined contribution pension plans might increase by March 2012 as a result of these changes and added this to our previous calculations of the base case. Some of the assumptions we have made have, of necessity, been rather arbitrary. The numbers are intended purely to give a rough idea. Our assumptions and the results of our calculations can be found in Figure 6.

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6 See Akiko Nomura, "Kojingata Kakutei Kyoshutsu Nenkin no Kadai" [Issues for Defined Contribution Pension Plans (Individual Plans) in Japan], Shihon Shijo Kuwotari [Capital Market Quarterly], Winter 2006.

7 “Category” refers to the status within National Pension system. Self-employed people belong to Category 1, company employees and public service workers to Category 2, and spouses without income to Category 3.

Figure 4 Main Problems of Defined Contribution Pension Plans

Problems	Details
Contributions	· Contribution limits need to be increased · Participants in company plans should be allowed to make their own contributions
Extension of eligibility	· Public service workers should be allowed to join · Spouses with no income of their own (Category 3 insured persons) should be allowed to join · Employees of companies offering defined benefit plans but no defined contribution plans should be allowed to join individual plans · Age limit (currently 59) must be raised
Early withdrawal	· Participants should be allowed to make early withdrawals and/or borrow against their pension reserves · Maximum lump-sum withdrawal payment should be increased
Management of assets	· "Money management funds" and "money reserve funds" should be included in the principal-guaranteed product category · It should be made easier to exclude investment products
Abolition of special corporation tax	This tax has been suspended until March 2008, but it must be abolished altogether

Source: NICMR.

2. Increasing contribution limits

One point we need to remember when considering the impact of increasing contribution limits is that only a minority of company pension plans allow contributions up to the legal limit. As can be seen in Figure 5, the average monthly per capita contribution in fiscal 2004 by companies that offer only a defined contribution (and no defined benefit) pension plan was ¥13,643. This compares with a legal limit of ¥46,000.

Nevertheless, there are company pension plans that do allow contributions up to the legal limit, and some companies may be prepared to introduce defined contribution pension plans if the contribution limit was increased. Therefore, we could assume that increasing the legal limit might also result in a higher average contribution to such plans in general.

We calculated, first of all, that increasing the legal contribution limit for defined contribution company pension plans would result in an increase in the average monthly per capita contribution from ¥11,869 in fiscal 2004 to ¥23,000 by fiscal 2009-2012. Over 38 years a monthly contribution of ¥23,000 would total more than ¥10mn. We therefore assumed that average contributions could rise to this level. This also boosted the asset amount by ¥1,193.2bn compared with the base case (as of March 2012).

Since it is difficult to imagine that any change in contribution limits would apply only to company pension plans, we have assumed that employees not covered by either a defined benefit or a defined contribution company pension plan would see the limit on contributions to their individual plans increased from a per capita monthly average of ¥15,876 in fiscal 2004 to ¥20,000. This also boosted the asset amount by ¥15.5bn compared with the base case (as of March 2012).

Figure 5 Limits on Contributions to Defined Contribution Pension Plans

	Legal contribution limit (monthly amount)	Actual average contribution for fiscal 2004 (monthly amount)
Company plans		11,869
No defined benefit plan available	46,000	13,643
Defined benefit plan available	23,000	9,390
Individual plans		15,876
Self-employed persons (Category 1 insured persons)	68,000	20,811
Employees whose company offers neither a defined benefit nor a defined contribution plan	18,000	11,688

Source: NICMR, from handouts of the 14th Meeting of the Japan Defined Contribution Pension

3. Public service worker coverage of defined contribution pension plans

A debate is going on about the future of public service worker pensions. The proposal is that the Employees' Pension Insurance, to which private-sector employees belong, and the National and Local Public Services Mutual Aid Associations, to which public service workers belong, should be merged. According to a Cabinet decision of 28 April 2006 to set up a unified pension plan that would remove discrepancies between private- and public-sector pensions, the "third tier" of public service worker pensions, which corresponds to the benefits of private pension plans, is to be abolished in 2010, when a new public service worker pension system is due to be introduced. This new system is due to be based on the findings of a report by the National Personnel Authority on public- and private-sector pension plans and retirement benefits in other countries.

Although it remains to be seen exactly what will replace the "third tier," if a defined contribution pension plan is to be used in some way, it is likely to be either (1) a defined benefit pension plan with significantly lower benefits than those provided by the current "third tier" but with the option of taking out an individual plan to make up the shortfall or (2) a company-type plan.[8]

Membership of the National Public Service Mutual Aid Association numbered 1,086,000 as of March 2005, while that of the Local Public Service Mutual Aid Association numbered 3,151,000 as of March 2004. Assuming that 400,000 (roughly 10%) of the participants in these Associations join defined contribution pension plans by March 2012, we calculated that the assets of defined contribution pension plans would increase by ¥112.2bn, if public service workers were allowed to join an individual plan, and by ¥90.1bn, if a company-type plan was adopted.

8 In the United States, for example, federal government employees may join Thrift Savings Plan (TSP), while state employees may join a 457 plan, both of which are defined contribution plans. Both federal and state employees may also have an individual retirement account (IRA).

4. Allowing spouses with no income of their own to join individual plans

If a member of a defined contribution company pension plan leaves his or her company in order to marry and becomes a spouse with no income of his or her own (a Category 3 insured person), he or she can transfer the assets in his or her account to an individual pension plan but cannot continue to make contributions. If he or she has been a participant in his or her company plan for only a relatively short period and the amount of assets in his or her account is quite small, he or she may find that the plan's fees actually eat into those assets.

As of March 2005 there were 10,990,000 Category 3 insured persons. If they were allowed to join individual pension plans and 1% of them did so by March 2012, the membership and assets of defined contribution pension plans would increase by 110,000 and ¥30.8bn, respectively, compared with the base case.

5. Allowing participants in defined contribution company pension plans to contribute from their own salaries

If participants in defined contribution company pension plans were allowed to contribute to these plans from their own salaries, what percentage of members would do so and how much would they contribute?

In this report we have used the contribution levels and membership rates of Japanese employee share ownership plans (mochikabu-kai) as a basis of comparison. Although mochikabu-kai are very different from defined contribution pension plans (e.g., in that they enable employees to accumulate company stock and do not offer any tax benefits), they are similar inasmuch as members have to decide for themselves whether to join and how much to contribute.

In fiscal 2004, according to data from Nomura Securities, the average monthly contribution to such plans in Japan was ¥10,455, while, according to data from the Tokyo Stock Exchange, the average participation rate was 48%. Assuming that half this number (i.e., 24% of employees) started to contribute to their company plans in fiscal 2009-2011, we calculated that the asset amount of these plans would increase by ¥269.0bn by March 2012, compared with the base case.[9]

9 "Heisei 16nendo Jugyoin Mochikabukai Jokyo Chosa Kekka no Gaiyo ni Tsuite" [Overview of Survey of Employee Share Ownership Plans in Fiscal 2004], Tokyo Stock Exchange, 15 September 2005, and "Mochikabu Detabukku 2005" [Databook of Share Ownership in Japan 2005], Nomura Securities.

Figure 6 Impact of the Reforms to Japan's Defined Contribution Pension System

Assumptions

1. Increase in contribution limits
- Average per capita contributions to company plans are gradually increased to ¥23,000/month by fiscal 2009-2011
- Average per capita contributions to individual plans are gradually increased to ¥20,000/month by fiscal 2009-2011

2. Extension of eligibility to public service workers
- Public service workers become eligible to join in fiscal 2009. 400,000 (or 10%) join in the three years to fiscal 2011
  - Membership of National Public Services Mutual Aid Association (as of March 2005): 1,086,000
  - Membership of Local Public Services Mutual Aid Association (as of March 2004): 3,151,309
- Scenario I: ban on joining individual plans is lifted
  - Contributions: fiscal 2004 average for employees whose company does not offer a company pension (¥11,688/month, ¥140,000/year)
- Scenario II: system corresponding to company defined contribution pension system is adopted
  - Contributions: fiscal 2004 per capita average for company defined contribution plans offered alongside a defined benefit plan (¥9,390/month, ¥113,000/year)
  - No asset transfers from old system

3. Spouses with no income of their own (Category 3 insured persons) allowed to join individual plans
- Spouses with no income of their own become eligible to join in fiscal 2009. 110,000 (or 1%) join in the three years to fiscal 2011
  - Number of Category 3 insured persons (as of March 2005): 10,990,000
- Contributions: fiscal 2004 average for employees whose company does not offer a company pension (¥11,688/month, ¥140,000/year)

4. Participants in company plans allowed to make their own contributions
- Participants in company plans allowed to make their own contributions in fiscal 2009. Percentage doing so gradually increases to 24%, or half that of the percentage of employees contributing to share ownership plans (48%), by fiscal 2011
- Average per capita contribution: same as that of members of employee share ownership plans (¥10,455/month, ¥125,000/year)

Membership

(1000 persons)

	Increase as a result of reform	Base case membership	Total
Reform of the public-sector pension system	400	4,977	5,377
Lifting of ban on Category 3 insured persons joining individual	110	4,977	5,086

Assets

(¥bn)

	Increase as a result of reform		Base case assets	Total
	Company plans	Individual plans		
Increase in per capita contribution	1,193.2	15.5	5,237.2	6,445.9
Company plans	1,193.2			
Individual plans		15.5		
Reform of public-sector pension system				
Scenario I: ban on joining individual plans lifted		112.2	5,237.2	5,349.4
Scenario II: company plan type adopted	90.1		5,237.2	5,327.4
Category 3 insured persons allowed to take out individual plans		30.8	5,237.2	5,268.0
Participants in company plans allowed to make their own contributions	269.0		5,237.2	5,506.2

Source: NICMR.

In the above we have estimated the impact on defined contribution pension plans of (1) increasing contribution limits, (2) allowing public service workers to join such plans, (3) allowing spouses with no income of their own to join individual plans, and (4) allowing participants in defined contribution company pension plans to contribute from their own salaries. What we have not attempted to do, however, is to estimate any synergy effect from implementing these reforms simultaneously. Also, as we have estimated the impact in relation to the base case, the increases in assets in Cases (1) - (4) do not take account of the increase that would result from transfers of assets from tax-qualified pension plans. The overall impact of the above reforms could therefore be greater than our estimates suggest.

IV. Conclusion

1. Comparison with the growth of 401(k) plans in the United States

As we reported above, assuming certain conditions (principally the impact of the transfer of participants and assets from tax-qualified pension plans), we estimated that the membership and assets of defined contribution pension plans in Japan would be 7,250,000 and ¥9,608.3bn, respectively, by March 2012, when tax-qualified pension plans are due to be abolished. Similarly, we saw from some simple estimates that, if the present rules governing defined contribution pension plans were reformed in the light of a review due to be carried out five years after the Defined Contribution Pension Plan Law came into force, there would be scope for further expansion.

Let us now compare the likely growth of defined contribution pension plans in Japan with that of the historical growth of 401(k) plans in the United States.[10] 401(k) plans were started in 1981. By 1985, four years later, membership had grown to 10,320,000 (or 11.7% of private workers). By 1991, 10 years later, this had grown to 19,040,000 (or 20.0% of private workers).[11]

In Japan, membership of defined contribution company pension plans is currently 1,930,000. This is equivalent to 5.2% of the total membership (37,130,000) of the Employees' Pension Insurance and the Mutual Aid Associations (i.e., Category 2 insured persons) as of March 2005.[12] By March 2012, following the abolition of tax-qualified pension plans, we estimate that this figure will have increased to 19% (7,080,000 members), assuming that the number of Category 2 insured persons remains largely unchanged. Although our membership figure is an overestimate (see above), it does show that the outlook for defined contribution pension plans in Japan is comparable to that of 401(k) plans in the United States.

10 Because of the limitation of data, we have not attempted to compare Japanese individual pension plans with US individual retirement accounts.

11 "Private Pension Plan Bulletin," US Department of Labor, Summer 2004. We have used this publication because it is frequently cited as a source of data on company pension provision in the United States.

12 Although the data points are different, we have taken the view that any change in the number of Category 2 insured persons is likely to be less significant than in the membership of defined contribution pension plans.

2. Defined contribution pension plans and investment in securities

Defined contribution pension plans require participants to choose from a range of investment products, including investment trusts. For many plan participants this is their first encounter with investment trusts, which are believed to account for roughly 30% of the assets of both company and individual defined contribution pension plans. This is already a much higher proportion than the figure for personal financial assets (3.4%), and it will be interesting to see whether it rises even more (e.g., to the figure for mutual funds as a proportion of 401(k) plans in the United States (50%)).[13]

Another interesting finding is that just under 60% of mutual fund investors in the United States say that their first purchase of a mutual fund was via a defined contribution pension plan.[14] It will be interesting to see whether the experience of investing and owning an investment trust through a defined contribution pension plan in Japan leads to more people investing in securities through a taxable brokerage account—in other words, whether the growth of defined contribution pension plans helps to encourage people to "shift from deposits to investments."

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13 According to the 2006 Investment Company Fact Book, Investment Company Institute (ICI), May 2006, mutual funds accounted for 50.7% of the assets of 401(k) plans in 2005.

14 Profile of Mutual Fund Shareholders, Fall 2004, ICI.