The Expert Panel's Report on Government Employee Pension Reform

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I. Public employee pensions revised with integration of employee pensions

Proposed legislation to integrate employee pensions, namely by integrating Employees' Pension Insurance, the public pension system for private-sector employees, with the mutual aid pension programs for public employees, was passed into law by the upper house on 10 August 2012 as part of the package of legislation pushing the integrated reform of social security and taxes.

The mutual aid pension programs comprise two elements, the public pension portion and the "occupational" portion, which equates to private-sector corporate pensions. To integrate these with Employees' Pension Insurance, a decision has to be made on how to handle the occupational portion. The legislation for integrating employee pensions does not contain specific instructions in this regard. Article 2 of the appendix of that bill calls for abolishing the occupational portion and establishing a new government employee pension system, with the parameters of the new system to be debated during 2012, after which the necessary measures will be devised pursuant to separate enabling legislation based on the results of that debate.

As part of this process, an expert panel on retirement benefits and the occupational portion of mutual aid pension programs was put together in April 2012. Prior to that in March, a survey by the National Personnel Authority (NPA) found that the retirement benefits of public employees were roughly ¥4 million higher than those for private-sector employees[1], and after its seventh meeting the expert panel published a report on 5 July citing the need to close the gap in pension benefits between government and private-sector workers and to establish a new system after the occupational portion is abolished.

The report says that the most appropriate way to close this public-private gap would be to reduce the amount of the lump-sum severance payment. In regards to the new system after the occupational portion is abolished, the panel wrote that of three

[1] National Personnel Authority, "*Minkan no Kigyounenkin oyobi Taishokukin no Jittaichousa no Kekka narabini Tougai Chousa no Kekka ni kakaru Hon'in no Kenkai ni tsuite*" (Results of a survey of private-sector corporate pensions and retirement payouts and NPA's view of those results), 7 March 2012.

possible approaches, a traditional defined benefit plan, a cash balance plan[2], and a defined contribution plan, the most appropriate would be a pension modeled after the cash balance plan used in the private sector.

II. The expert panel's report and actual condition of corporate pensions

The follow-on system to the occupational portion of public employee pensions is positioned as equivalent to private-sector corporate pensions. By proposing to close the roughly ¥4 million gap between public and private-sector pensions, the expert panel's report takes account of the current status of private-sector pensions while attempting to maintain balance between the occupational portion and private-sector corporate pensions. We list below the remarks on corporate pensions in the expert panel's report that we found worth further discussion in the context of comparisons with private-sector pensions.

1. Participation in corporate pensions

The expert panel's report, commenting on the availability of corporate pensions, notes that "56.0% of private-sector corporations with at least 50 employees offer a corporate pension, and of those 90.5% offer some sort of defined benefit plan (either a defined benefit corporate pension, Employees' Pension Fund, or a qualified retirement pension), 24.7% offer a defined contribution corporate pension, and 10.0% answered unknown or other (the numbers total more than 100% because multiple answers were allowed). Furthermore, a survey by the Pension Fund Association at end-FY 2010 found that about 78% of pension plan participants (13 million) had a defined benefit plan and about 22% (3.7 million) had a defined contribution plan." [3]

These figures alone indicate that the bulk of pensions in Japan are of the defined-benefit (DB) type, but this only makes sense, given that DB pensions have been around for more than 50 years, versus the mere decade or so that has passed since DC plans were first introduced in 2001. In addition, while the number of participants and amount of assets held in DB plans have either been declining or flat in recent years, DC plans have recorded steady growth over the past 10 years in the number of companies offering them, number of participants, and assets (Figures 1 and 2). In what will be a drawn-out debate over introducing a new pension system for government employees, we think it would be best to ignore the current mix of defined

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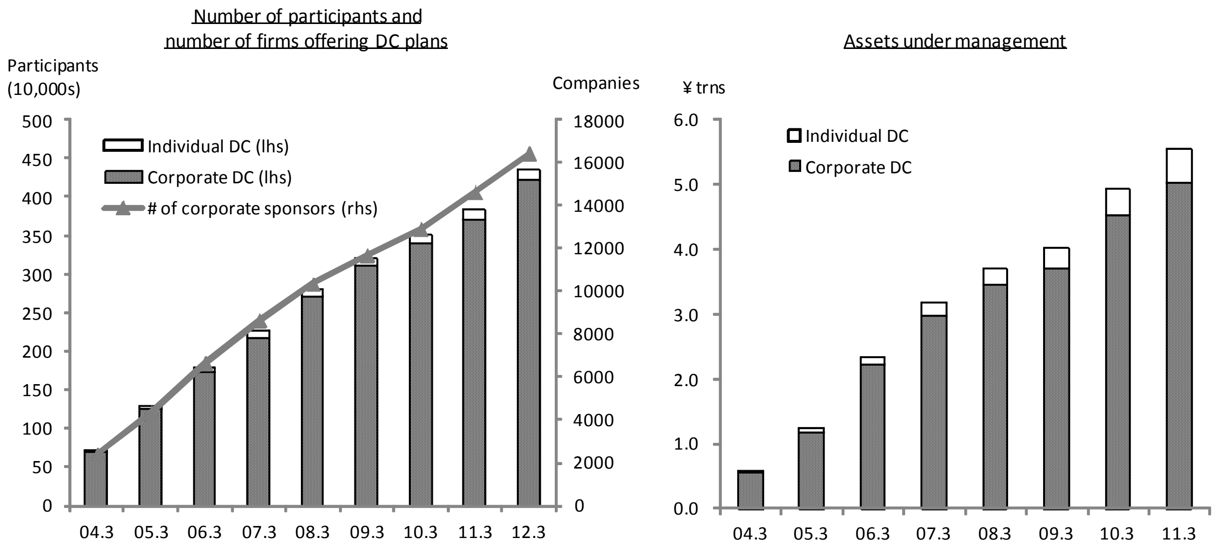
2 Cash balance plans are a type of defined benefit pension plan. Virtual accounts are set up for each subscriber, and the amount of pension benefit is determined based on the total amount of credits granted to those virtual accounts. A portion of the credits can be linked to JGB yields, making it possible to lessen the impact that interest rate fluctuations have on the level of funding compared with traditional defined benefit plans (such as an increase in pension liabilities resulting from a decline in yields), although the possibility of underfunding normally cannot be completely eliminated.

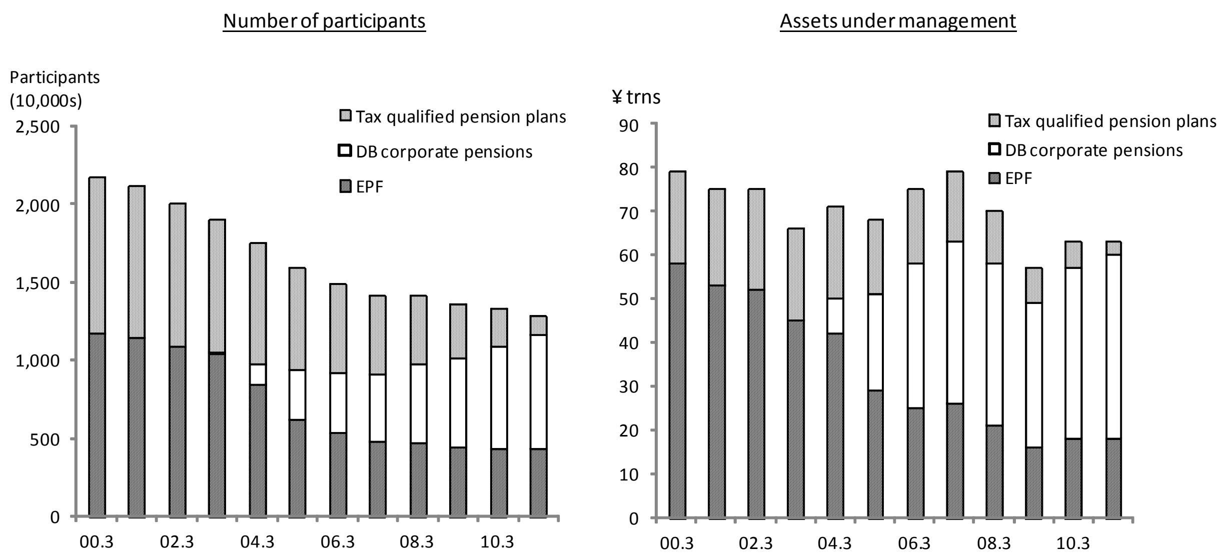
3 Page 15 of the expert panel's report.

Figure 1: Prevalence of DC plans



Source: Nomura Institute of Capital Markets Research, based on data from the Ministry of Health, Labour, and Welfare and from the Japan Association of DC Plan Administrators.

Figure 2: Prevalence of DB plans



Source: Nomura Institute of Capital Markets Research, based on data from the Pension Fund Association

benefit and defined contribution plans and instead take into account the possibility of a substantial increase in the presence of DC plans in the future.

We note that the 13 million (DB) and 3.7 million (DC) participants mentioned above are figures current as of March 2011, and some employees are enrolled in both types of plans. It would be inaccurate to fail to adjust for this double participation and assume, simply using the total of those two numbers as the denominator, that DB plans have an 80% share. Even the NPA survey quoted in the expert panel's report, which has 90.5% of companies offering DB and 24.7% offering DC (a total well over 100%), makes it clear that some companies offer more than one type of pension plan. Data from the Ministry of Health, Labor and Welfare also indicates that of the 16,564 companies offering a DC plan, 5,652 (about one third of them) also offer another type of corporate pension, such as a DB plan or the Employees' Pension Fund (EPF)[4].

2. The DB expected rate of return and DC assumed yield

The expert panel's report notes that both DB and DC plans "in principle assume a given rate of return (assumed yield) to calculate the contribution while working and the benefit after retirement."[5]

There is definitely a need to assume a rate of return in order to calculate the contribution required for a given benefit in a DB plan. A DC plan, in contrast, does not necessarily need to have an "assumed yield." Out of 966 respondents to a Pension Fund Association survey taken in 2010, 250 (more than one-fourth) answered that they did not have an assumed yield[6].

The assumed yield in a DC plan is the expected rate of return that is attainable over the long term per the employee's investment instructions for his account. Companies whose first corporate pension is a DC plan or who introduce a DC plan as an add-on to an existing retirement plan do not have to set an assumed yield. On the other hand, companies that transition from an existing retirement plan (such as a DB plan or a lump sum retirement payout) to a DC plan typically feel the need to avoid making a change that is disadvantageous relative to the existing retirement plan, particularly to get labor to agree to it. By doing so, they can demonstrate pension benefits as good as the previous ones, provided that the DC contributions are set using the assumed yield and the employee achieves that assumed yield over the long-term. For example, if a company with 100 units in retirement benefits moves 20% of those over to a DC plan, with an assumed yield of X%, the company would have to contribute ¥Y per month in order to enable employees to build up 20 units in DC assets by the time they are 60.

Under a DB plan, if the investment performance is insufficient to achieve the expected rate of return, the company could be forced into making additional contributions to cover the shortfall. In contrast, the assumed yield under a DC plan is nothing more than a target for achieving the same level of benefits as under the previous plan, and meeting this target is up to each employee. Using the previous

4 http://www-bm.mhlw.go.jp/topics/bukyoku/nenkin/nenkin/kyoshutsu/unyou.html
5 Page 15 of the expert panel's report.
6 Pension Fund Association, "*Dai sankai Kakuteikyoshutsu Nenkin Seido ni kansuru Jittaichousa- Chousakekka*" (Results of third survey of defined contribution pension plans), December 2010 (in Japanese).

example, employees that do not mind DC assets of only 10 rather than 20 units by their 60th birthday would be free to make investments that generated less than the assumed yield, and conversely employees who want assets of 30 units could accept higher risks in pursuit a return higher than the assumed yield. Thus the DB plan's expected rate of return and the DC plan's assumed yield are false cognates.

We note some other remarks in the panel's report, including that "it may be true that by equalizing total retirement benefits between the public and private sectors under certain assumptions, the final tax burden would be unchanged," and that "one could argue that from the perspective of the total retirement benefit, the final tax burden is the same under both a DB plan and a DC plan."[7] Looking at the whole report, including its appendices, if the new pension plan for government employees winds up being a DB plan, the employer (the government) would make additional contributions to cover any shortfalls, whereas if it turns out to be a DC plan, other retirement allowances would be increased in the event of the investments not doing well. This means that the total retirement benefit, and hence the employer's burden (taxpayer burden), would be the same in either case. If this understanding is correct, such a plan design would not be the norm in the private sector.

3. Investment instructions under a DC plan

1) Insider trading and DC pensions

The expert panel's report makes several references to investment instructions under a DC plan[8].

In one of those, it says "government employees are subject to insider trading rules under the Financial Instruments and Exchange Act as well as other trading restrictions that could be applied depending on the government agency where they work, with a view toward ensuring the people's faith in the rules being fairly administered. Some are of the opinion that there is little to worry about in this regard, given that actual investments are more often made in mutual funds (investment trusts) than in individual stocks. Others have pointed out, however, that government employees do have access to information, including on economic , diplomatic, and defense policies, that could impact the market overall, and that it is important to avoid not only actual violation of the law but also any appearance that they are using such information when making investments."

Normally, investment instructions under a DC plan are not so dynamic as to enable trades based on information obtained ahead of others that capture intraday market moves. There are two types of DC investment instructions, changes in the allocation of contributions and changes in existing asset allocations (switching). The former changes the investment products to be purchased with future contributions, and the timing of those contributions is pre-determined, irrespective of market moves. The latter consists of the sale of all or a portion of previously acquired investment

7 Pages 16 and 19 of the expert panel's report.
8 Pages 16-17 of the expert panel's report.

products, and thus can reflect the plan participant's own market view, but such a move is not very dynamic either, in that the change in allocation is not completed until several days after it is initiated. In fact, a look at the trading data in DC plans does not show much switching activity by participants. Nomura Securities' DC plan administration department has data that shows that only 10.7% of participants had done any switching since they began contributions as of end-FY 2011[9].

In addition, the traditional lineup of investment products in a DC plan comprises mutual funds, savings deposits, and insurance products, and does not include individual stocks, as also noted in the above excerpt from the expert panel's report[10]. Investment in a portfolio of mutual funds is handled by the asset management company's portfolio manager, and thus there is no way for individual investors who have obtained nonpublic information to affect the outcome. Furthermore, all trading of mutual funds by individual investors, not just those under a DC plan, is done at a price determined after the order is submitted. This is because trades are based on the net asset value calculated from closing prices on the day of the trade, a value unknown to the investor when the trade is placed. There have been virtually no concerns that insider trading regulations would become an issue with the implementation of DC plans at private-sector corporations.

It would generally be very difficult for DC plan participants to anticipate in advance how nonpublic information would affect the net asset value of a mutual fund and thereby profit by trading ahead of other investors.

In addition, if such use of nonpublic information obtained at the workplace by a plan participant were to become an issue, we think it could be dealt with by suspending trading for a set period of time based on pre-established rules. We note that DC pensions for federal government employees were introduced in the US in 1986. The pros and cons of DC plans were debated at the time, and there is no evidence of any major dispute over rules on insider trading or similar use of important nonpublic information[11].

2) DC investor education and investment instructions

The expert panel's report also noted that "some have expressed the opinion that in the case of a DC plan, (1) the employer is obligated to provide investor education, and the extra costs of providing this investor education probably needs to be taken into

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9 Nomura Securities Pension Support & Service Center Dept.,"*Kakuteikyoshutsu Nenkin Deita Bukku*" (Defined contribution pension data book), 2011 edition (in Japanese).

10 According to the Pension Bureau at the Ministry of Health, Labor and Welfare, DC pensions offer an average of 18 investment products, including 13.2 investment trusts, 2.2 savings deposits, 2.3 life and nonlife insurance products, and 0.5 monetary trusts. (As of 31 May 2012)
http://www-bm.mhlw.go.jp/topics/bukyoku/nenkin/nenkin/kyoshutsu/unyou.html (in Japanese)

11 See Akiko Nomura, "*Beikoku no Renpou Koumuin Muke Kakutei Kyoshutsugata Nenkin–1986 nen Kaikaku no Keii to Genjou*" (Defined contribution pensions for US Federal government employees – 1986 reforms and current status), Capital Market Quarterly, Summer 2012 (in Japanese).

account, and (2) while the plan participant provides investment instructions, given that the taxpayers expect public employees to devote their time to their public duties, it may be contrary to taxpayers' expectations for public employees to receive investor education and pay attention to asset investment while performing their public duties, and thus this approach may not be suited to public service." They also note that it has been argued that "because individual public employees also need to do their work from a long-term viewpoint without worrying about short-term investment performance, DB pensions are more suited to their needs."

The manufacturing sector has the largest number of companies that have introduced DC plans. Although it is the number of pension plans rather than the number of plan participants that is known, we note that out of 4,141 plans, 1,507 were established by manufacturers, and only 245 by companies in the financial sector[12]. This means that most DC plan participants' main business is something other than asset management, but there does not seem to be anyone arguing that their receiving investor education and giving investment instructions is getting in the way of their ability to create added value in their business on a daily basis.

In addition, it is probably safe to say that the importance of long-term investing is always covered in the investor education offered with DC plans. Because individuals cannot as a rule withdraw funds from their DC accounts until they are 60 years old, they have little reason to fret over short-term investment performance, and this is an environment that is conducive to long-term investing. If DC investor education is properly given, we think there is overall little reason to be concerned that a large number of plan participants will start worrying over short-term investment performance.

4. Comparing the investment performance of DC and DB plans

The expert panel's report also noted that "in America, there are surveys showing that the investment performance of DC pension plans has been better for those individuals who have relied on advice from investment professionals than for those who have selected their own investments, and some are of the opinion that this is analogous to investments in a DB pension generating a higher yield than investments in a DC pension."

In the US, there are two types of DC plans, those like a 401(k) in which the plan participants give investment instructions and, less common, those where they do not. It is not clear to the author whether the first portion of the passage quoted above is referring to differences in investment performance between these two types, or whether it is comparing the investment performance of plan participants who use investment advisory services offered through 401(k) plans and those who do not. That being said, the US Department of Labor provides straightforward data comparing the investment performance of 401(k)s versus DB plans in the US, as shown in Figure 3[13].

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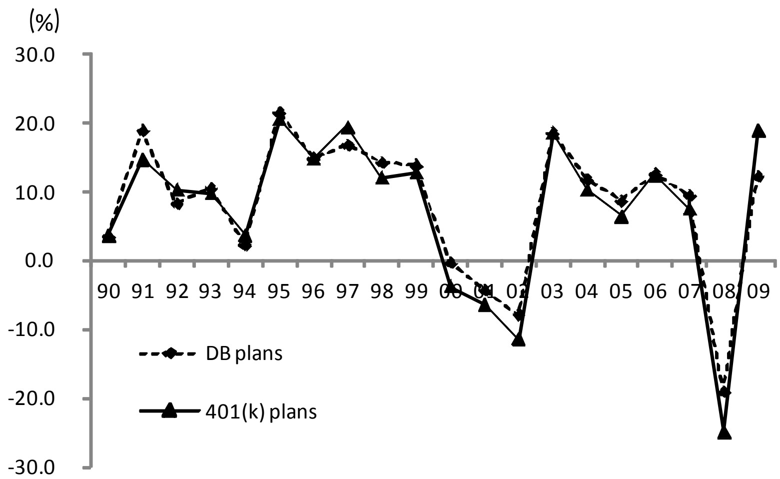
[12] http://www-bm.mhlw.go.jp/topics/bukyoku/nenkin/nenkin/kyoshutsu/unyou.html

[13] US Dept. of Labor, “Private Pension Plan Bulletin Historical Tables and Graphs,” Dec. 2011.

Figure 3: Investment performance of DB plans versus 401(k) plans in the US



Source: Nomura Institute of Capital Markets Research, based on the U.S. Dept. of Labor's "Private Pension Plan Bulletin Historical Tables and Graphs," Dec. 2011

This data shows that 401(k) plans have a somewhat larger fluctuation, and also shows that the geometric average return from 1990 until 2009 was 7.8% for DB plans, versus 6.8% for 401(k) plans.

This alone seems to suggest that DB plans have outperformed, but it is close to meaningless to look only at the figures for investment performance when comparing the two types of plans. The performance of DB investments was in the same direction as that for 401(k) plans, and there were also years in which that performance was substantially negative. In such years the performance was definitely below the expected rate of return, and this led directly to increased contributions from the employer, which in the case of public employee pensions meant an increased burden on the public purse.

The expert panel's report proposed that "when designing cash balance plans, funding and the setting of indicators should be done more conservatively than the methods currently allowed by law for private-sector corporate pensions."[14] Although the details are unknown, judging from the materials in the appendix of that report, those plans would become underfunded when investment performance turned negative.

III. Conclusion

As noted above, DC plans have become increasingly common since they were introduced in 2001. During that time, there has been a sustained effort to work out their regulatory issues, and pension-related legislation was passed in 2011 that finally allowed, after 10 years of consideration, employee contributions to corporate DC

[14] Page 21 of the expert panel's report.

plans. In addition, proposals for enhancing DC plans were included in a summary report from the growth finance promotion committee published by the Cabinet Secretariat's National Strategy Unit on 9 July 2012, as well as in the Comprehensive Strategy for the Rebirth the Japan, the Cabinet Decision made on 31 July.

Looking at trends abroad, in the US, public pension reforms in the 1980s sparked changes to pensions for federal government employees, away from a pure DB plan to a combined plan including both DB and DC pension elements. The Thrift Savings Plan (TSP), the new DC plan resulting from the change, has grown steadily in both number of participants and assets, and is now the largest pension plan in the US[15]. There are thus examples of combined DB/DC plans functioning well for a government employee pension program.

There are advantages and disadvantages to both DB and DC plans, and one is not necessarily clearly better than the other. The discussion cannot begin without first shedding preconceived notions and gaining an objective grasp of the situation in the private sector. We think it is important for the debate over reforming Japan's public employee pensions to move forward based on a wide range of perspectives.

15 See the paper noted in footnote 11.