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OAP/FAD Conference:
Designing fiscally sustainable and equitable pension systems in Asia in the post-crisis world

Session 5: *The role of private pensions in providing equitable and sustainable pensions in the post-crisis world*

The future of occupational pensions in Japan

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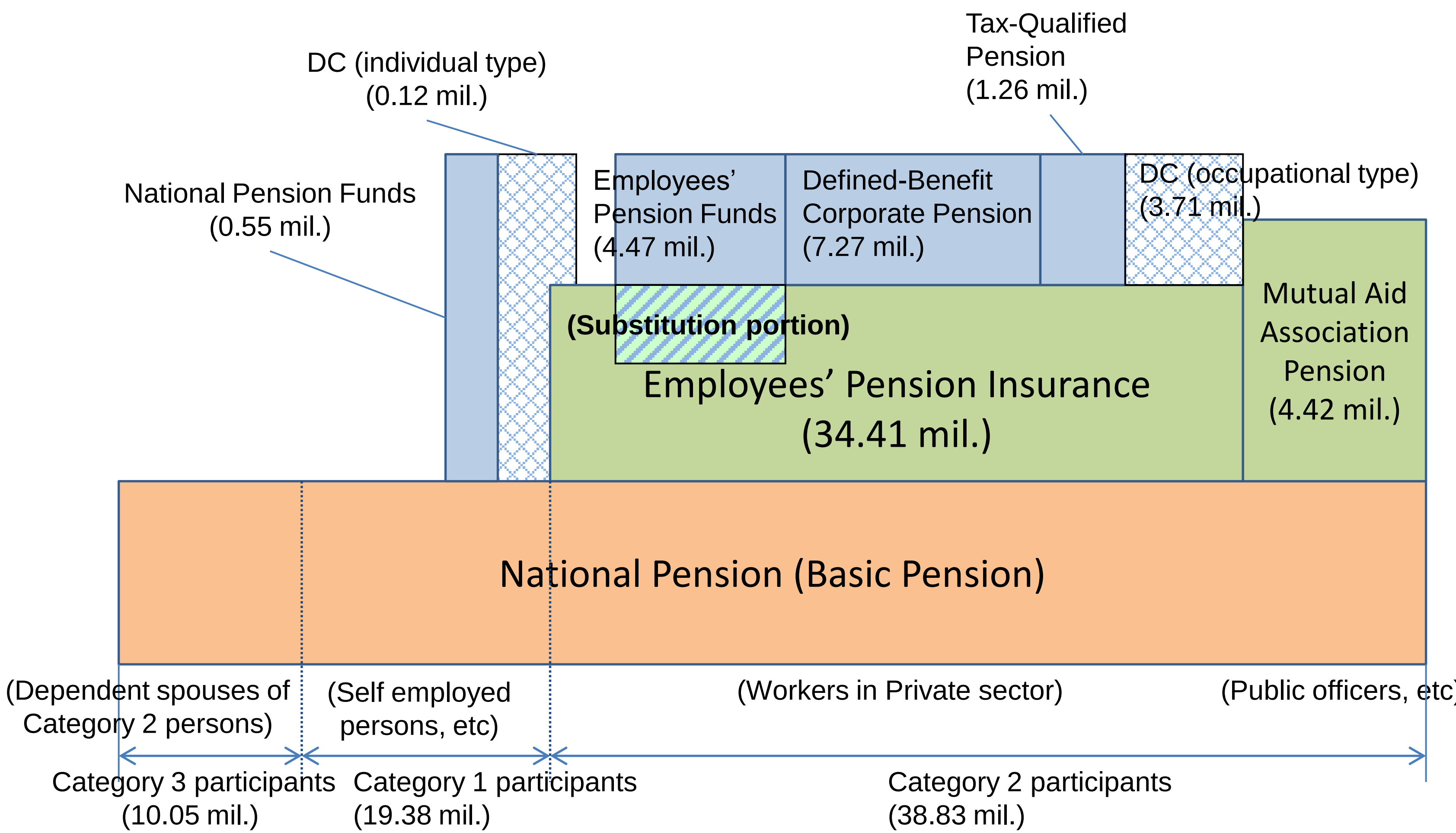
Pension system in Japan

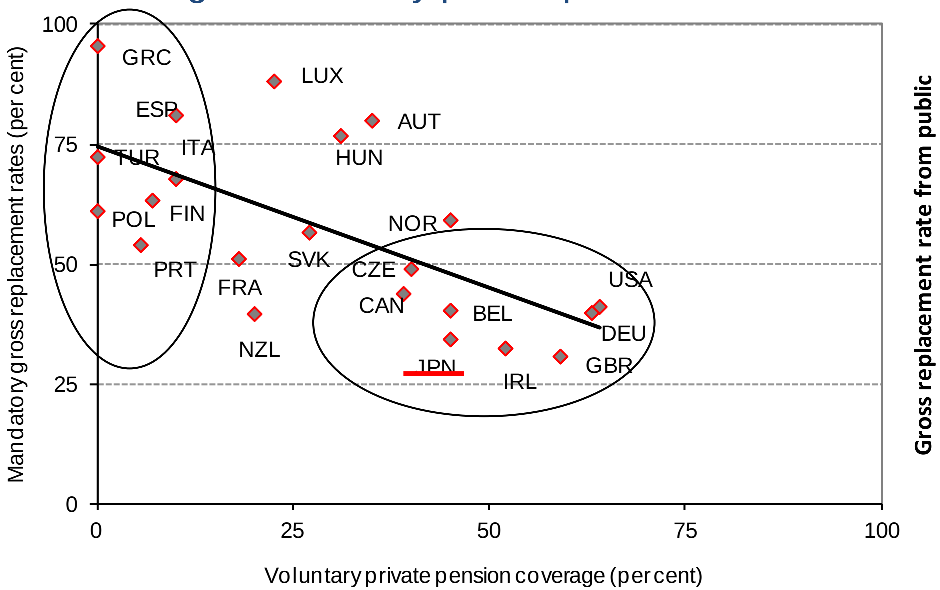
(Number of active participants as of March, 2011)



Source : Ministry of Health, Labor and Welfare

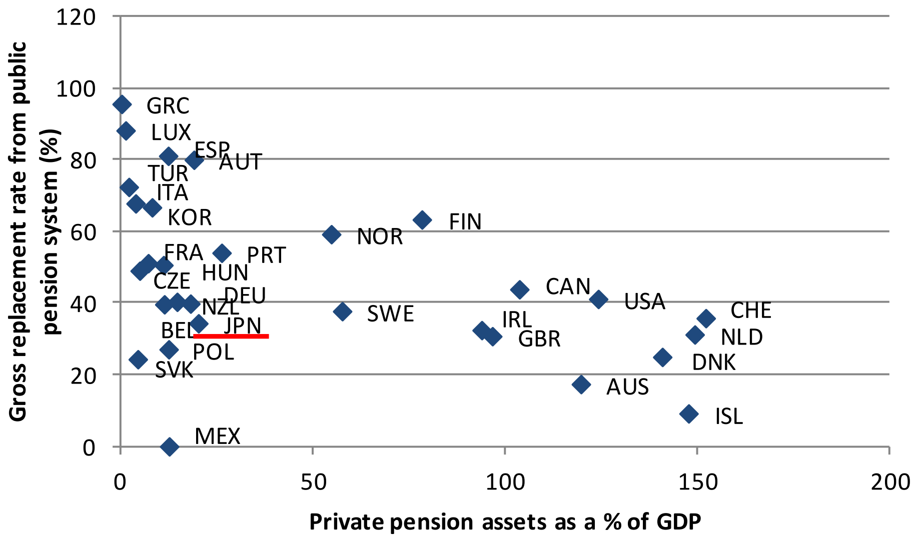
Current Position in Global Comparison

Average projected mandatory pension and coverage of voluntary private pensions



Source: Pensions at a Glance: Public Policies across OECD Countries 2007 Edition - OECD © 2007

Private pension assets compared with the public pension system's gross replacement rate, 2007



Source: OECD Private Pensions Outlook 2008 - OECD © 2009

- ✓ For the calculation of replacement rates, the average worker is assumed to enter the labor force in 2005 and earn the average wage.
- ✓ The coverage ratio for Japan is based on only external funding schemes. The ratio will be somewhat higher if traditional lump-sum plans were included.

Development of Lump-sum plans

18th ~ 20th Century (Edo period: ~1867)

Granting "Goodwill" for former employees who finished their term of service

→ Funding for the establishment of their own business

19th ~ 20th Century (Meiji and Taisho period: ~1926)

Industrial Revolution

Compulsory in-house saving deposit

Labor Unions

Severance pay / Jobless compensation

→ Lump-sum plan provided by employers

1936 Enactment of compulsory retirement lump-sum plans

Financed by Employer and Employees

→ Although the law was repealed with the enactment of Employees' Pension Insurance Law in 1944, lump-sum plans became more popular.

1952 Tax preferable treatment for the provision of employer's book reserve

→ Phased out by 2002 with the public intention to promote external funding schemes.

Development of Pension Plans

1954 Fundamental revision of Employees' Pension Insurance (EPI) Law

1961 Enactment of National Pension (NP) Law

1962 Amendment of Corporate Tax Law

Implementation of Tax Qualified Pension Plans (TQPPs)

1965 Pension reform Improvement of the level of public pension benefits

Implementation of Employees' Pension Fund (EPF) scheme

1990s Deregulation of investment restrictions

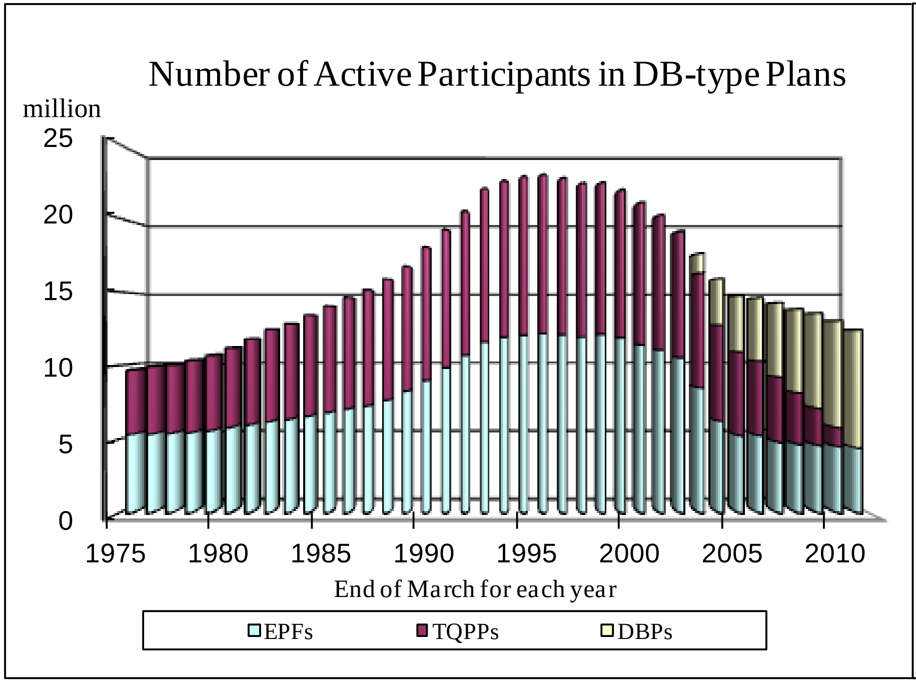
2000 Implementation of New Retirement Benefits Accounting Rule

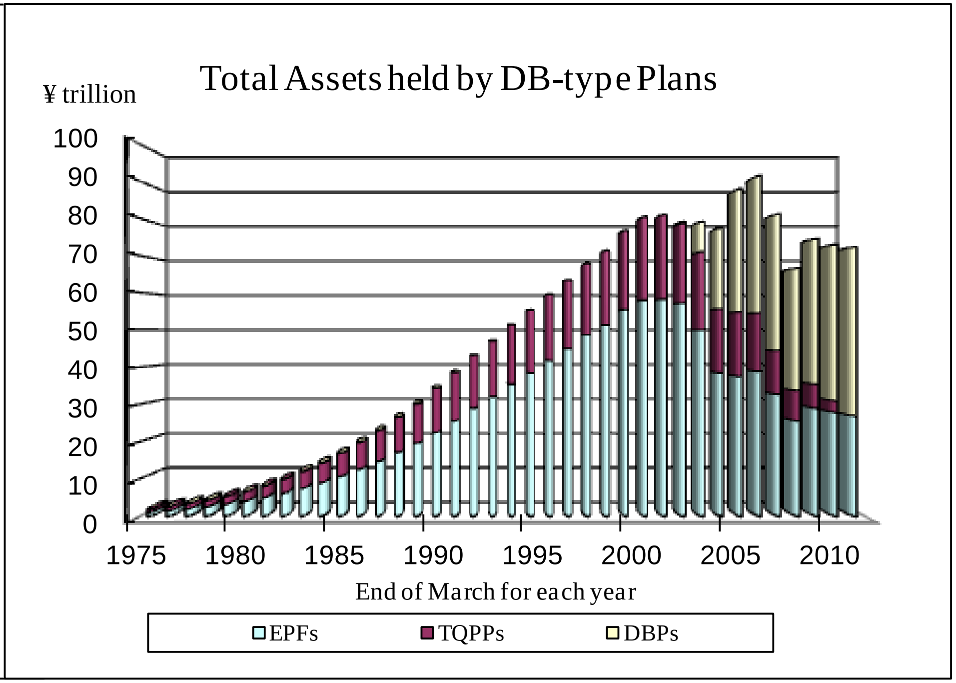
2001 Enactment of Defined Benefit Corporate Pension Law and Defined Contribution Pension Law

➡ Great phenomenon of "Daiko Henjo"

2012 Tax preferable status for TQPPs was expired.

Development of DB-type Pensions

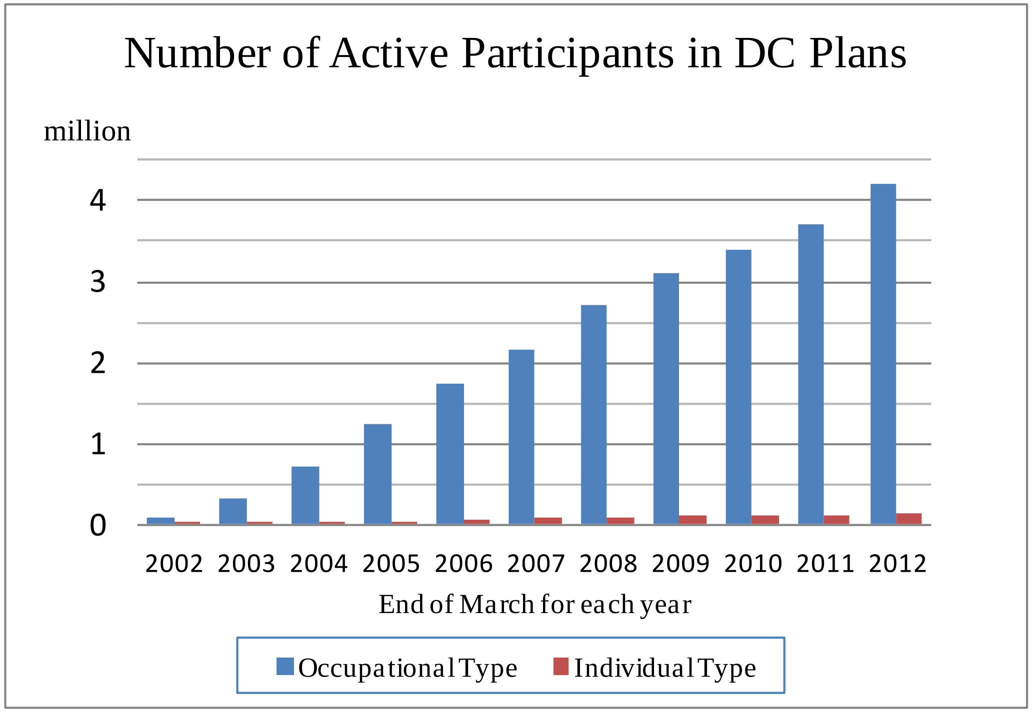




Source: Trust Companies Association of Japan

- ✓ DB corporate pension law was introduced in 2001.
- ✓ The tax preferable status of TQPPs was expired at the end of March 2012.
- ✓ EPF can be converted to a plan of other type, such as DBP, by transferring its substituted benefit obligations and corresponding assets to the government.

Development of DC Pensions

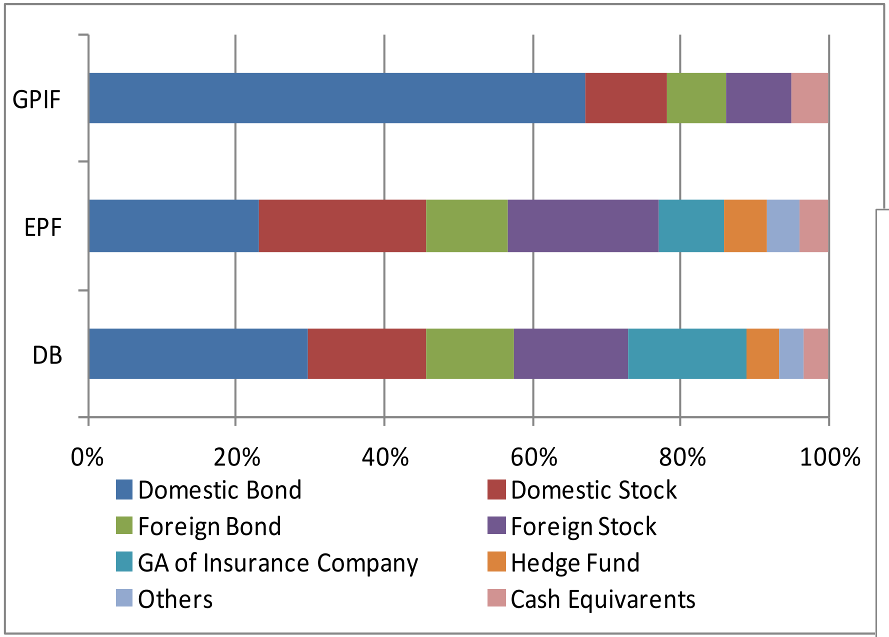


Source: Ministry of Health, Labor and Welfare

- ✓ DC pension law was introduced in 2001.
- ✓ While the number of active participants for “occupational type” plans has been growing steadily, the number for “individual type” plan is still negligible.
- ✓ The total asset for occupational type plans as of the end of March, 2012 was about \ 6 trillion.

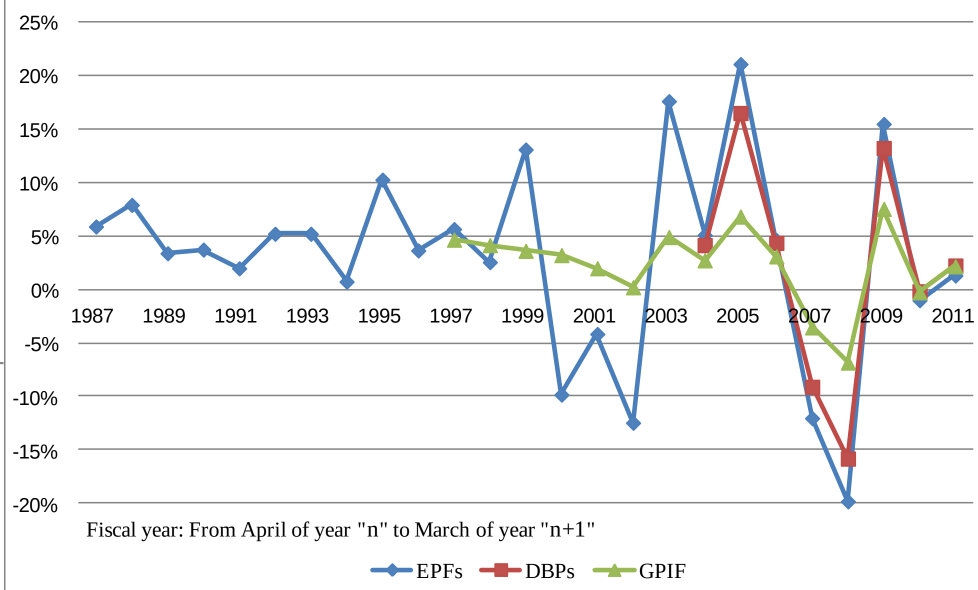
Investment Strategies and Performances

Total Pension fund Asset-Mix by Type



End of March, 2011 (GPIF: Policy Asset-Mix)

Investment Performances of Pension Funds



Source: Pension Fund Association, Government Pension Investment Fund (GPIF)

Coverage, Forfeiture, Reduction of Benefits

- ✓Most pension plans are designed so that all or part of the sponsor’s traditional retirement lump-sum plans are transferred to the pension plans.
- ✓Because the traditional retirement lump-sum plans are designed to pay the retirement benefits only to regular employees, part-time workers and non-designated workers, such as workers in supplementary jobs, are usually out of the pension plan coverage.
- ✓Although its execution is relatively-rare, there exists so-called “Bad-boy clause” and all or part of lump-sum benefit can be forfeited in the case of punitive dismissal.
- ✓In the case of sponsor’s financial difficulty, for example, pension benefits including the “accrued” part and even those already in payment can be reduced provided that the amendment meets the prescribed criteria in both process and necessity.

Features of DB plan's benefit formula

Huge variety of Lump-sum Benefit Formula

$$S_{x,t}^{(h)} =$$

Flat-rate formula

$$\alpha_t^{(h)}$$

Final salary formula

$$\alpha_t^{(h)} \cdot B_x$$

Point system formula

$$v_t^{(h)} \cdot \sum_{y=x_e}^{x-1} P_y \cdot u$$

Cash Balance formula

$$v_t^{(h)} \cdot \sum_{y=x_e}^{x-1} \left\{ c_t \cdot B_y \cdot \prod_{z=y}^{x-1} (1+i_z) \right\}$$

x : age at separation

t : tenure at separation

h : reason of separation

α : flat rate or rate of benefit payment

B : salary for the basis of benefits

v : adjustment factor (ex. 100%, 80%, $\cdots$)

P : point based on position, performance, etc.

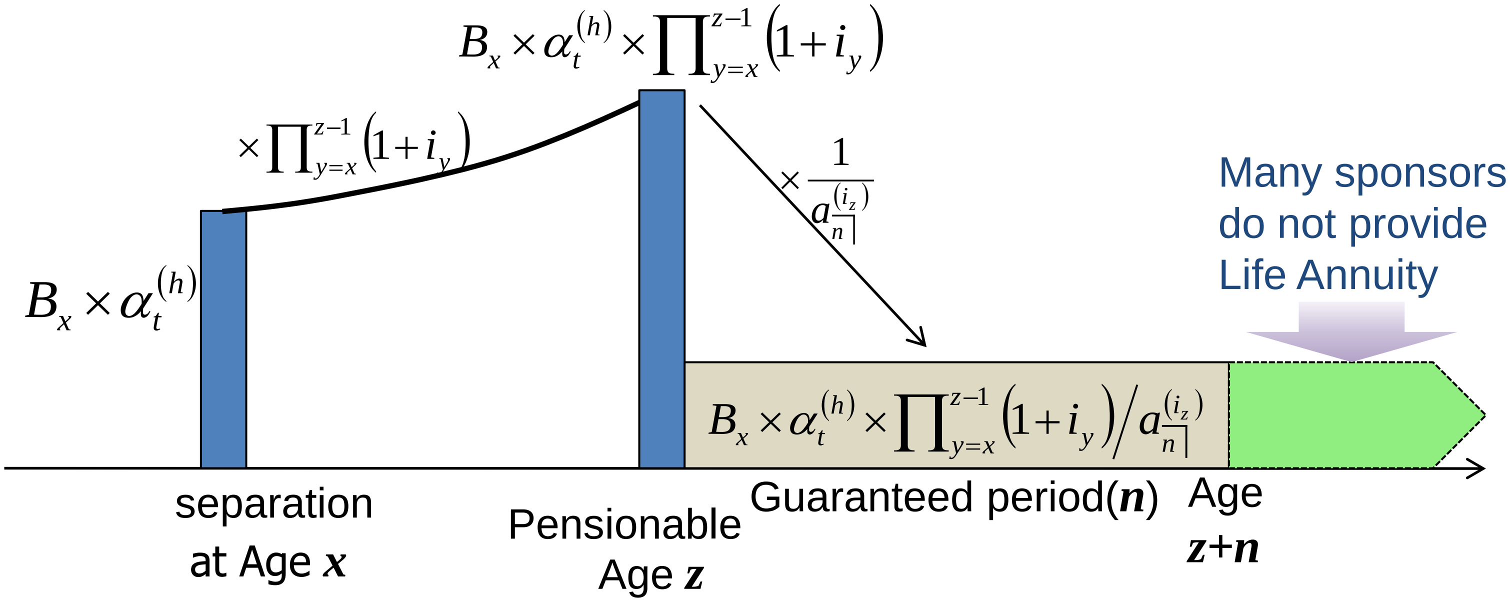
u : unit value for points

c : pay credit rate

i_z : interest credit rate at age z

Lump-sum to annuity

Conversion of the lump-sum benefit at the separation from service to the annuity payable in retirement

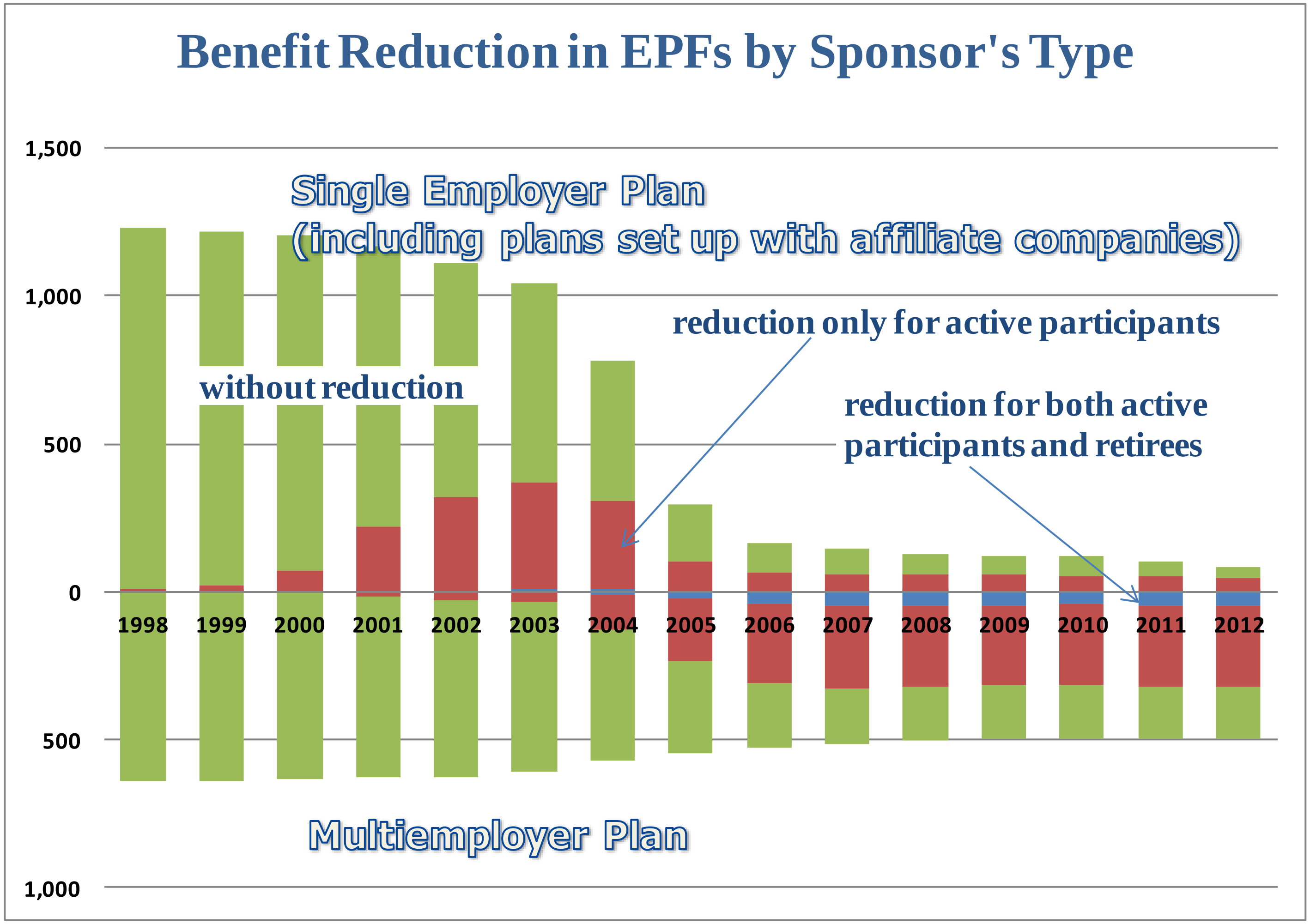


This term would be regarded as the revaluation factor from ***x*** to ***z***

Traditional US pension formula $B_x \times \beta_t$

Common Japanese pension formula $B_x \times \alpha_t^{(h)} \times \prod_{y=x}^{z-1}(1+i_y) / a_{\overline{n}|}^{(i_z)} = B_x \times \prod_{y=x}^{z-1}(1+i_y) \times \frac{\alpha_t^{(h)}}{a_{\overline{n}|}^{(i_z)}}$

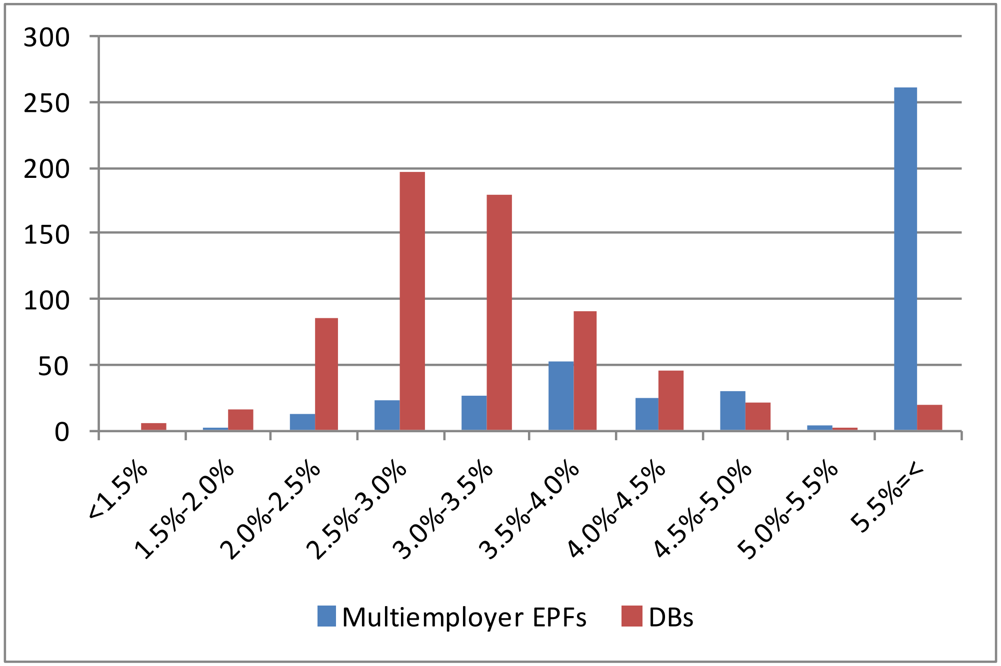
Benefit Reduction



Source: Ministry of Health, Labor and Welfare

Setting discount rates for funding purposes

Number of pension funds by plan type and discount rate rate (2011)



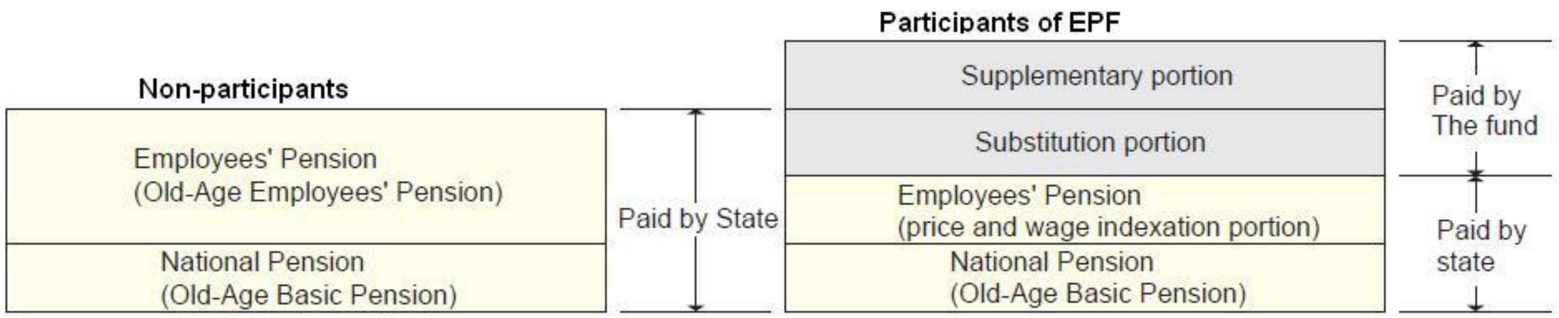
Source: Pension Fund Association

- Number is limited to pension funds that responded to PFA's research
- Discount Rate for Multiemployer EPFs is that for Supplementary portion

Outline of EPF scheme

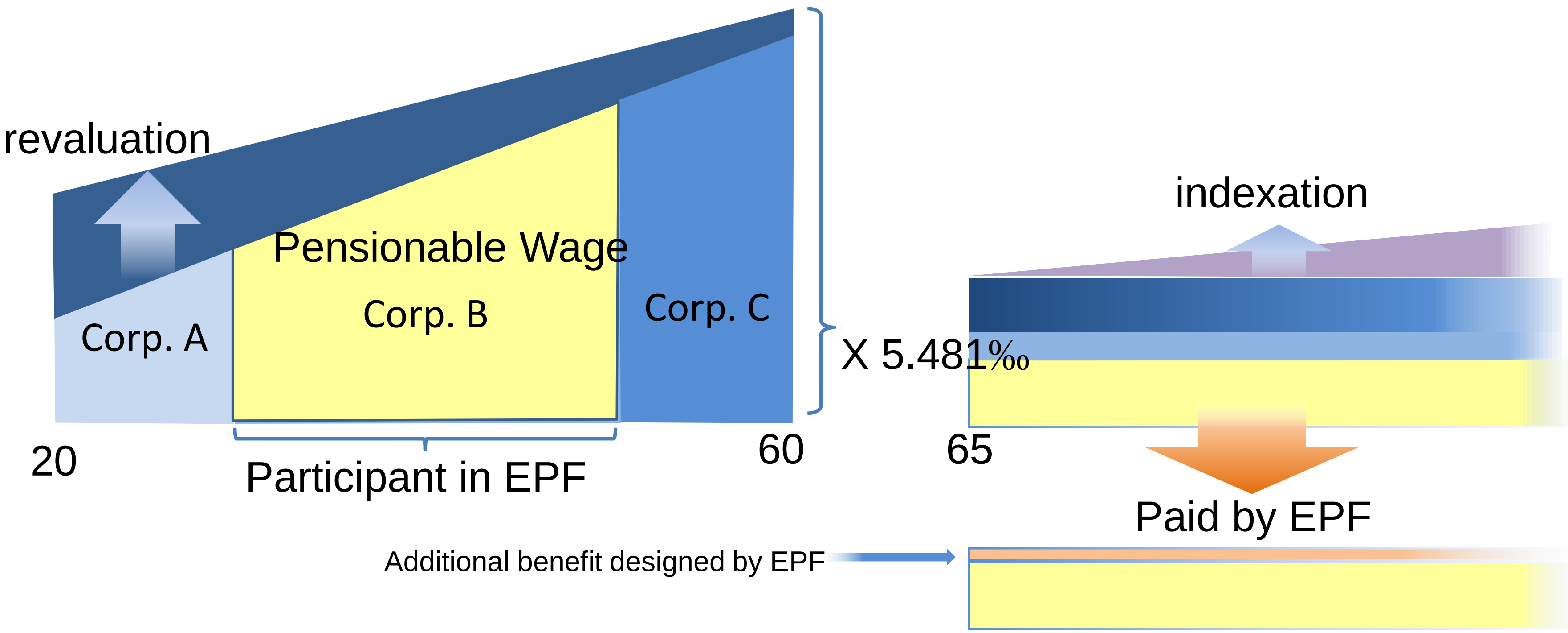
- ✓ EPF scheme was introduced by the reform of the Employees' Pension Insurance (EPI) Law in 1965.

Structure of Employees' Pension Fund Benefits



- ✓ EPFs substitute part of Old-Age Employees' Pension (earning related portion excluding the indexation) and pay their own supplementary benefits.
- ✓ An employer who provides EPF and its participants are exempted from paying part of contributions to EPI in return for the substitution (exempt premium).
- ✓ While funding standards for the Supplementary portion are based on normal actuarial cost methods, the financial structure of the Substitution portion is quite unique.

Substitution of Old-age Employees' Pension



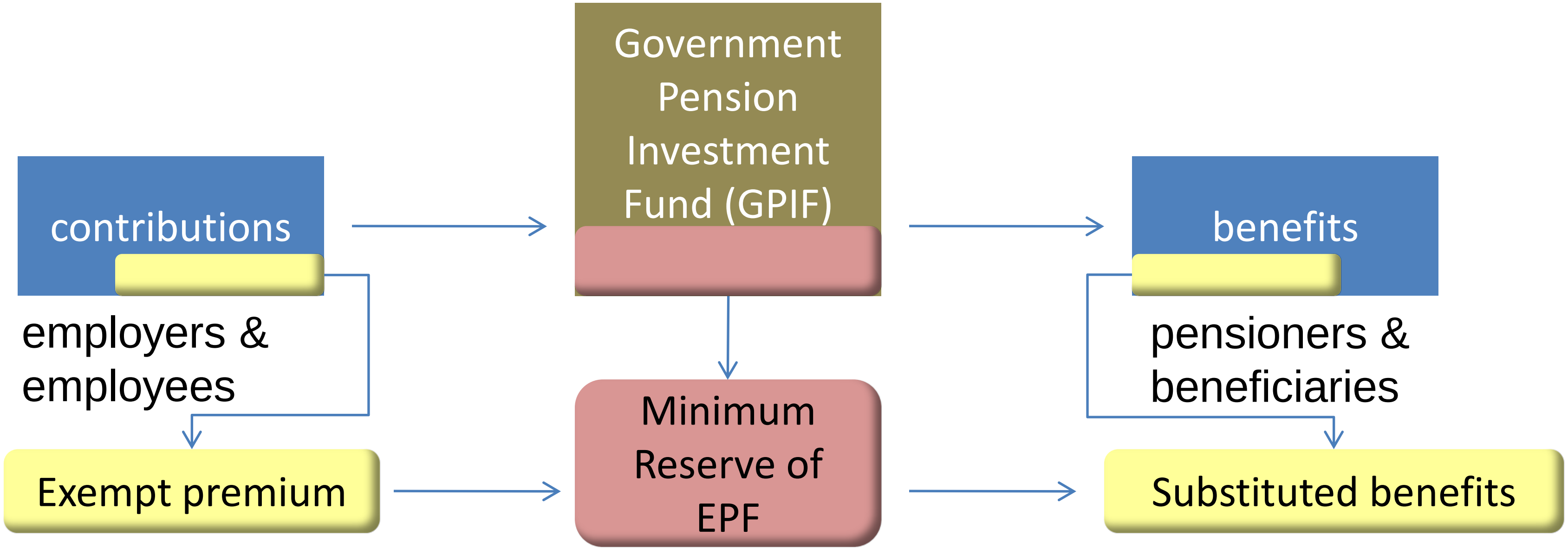
✓EPFs substitute only Old-age pension benefits in EPI (no survivors' and disability benefits).

✓EPFs do not substitute the part of benefits related to wage revaluation and indexation.

Financial Structure of EPFs

- ✓ Although the government intended to aim at the financial neutralization between EPFs and EPI, due to the administrative difficulties, there used to be some arbitrage in the funding standards.
- ✓ Current exempt premium for each EPF is calculated reflecting its demographic structure, wage profile, and applying the uniformly prescribed actuarial cost method and assumptions.
- ✓ Until 1999, the definition of Minimum Reserve was the accrued liability obtained by applying Traditional Unit Credit Method and prescribed assumptions (such as 5.5% discount rate).
- ✓ In 1999, following the prolonged economic slump, poor investment performances and low interest rates, the government decided to change the definition of the Minimum Reserve toward "financial neutralization" between EPFs and EPI.

Current Definition of Minimum Reserve



- ✓ Financial Structure of EPI is based on PAY-GO with the buffer fund (GPIF).
- ✓ The Minimum Reserve (MR) of an EPF is calculated using the Exempt premium, Substituted benefits and investment performances of GPIF, that is, MR is the amount calculated retrospectively assuming that the exempt premiums were managed by GPIF.
- ✓ Each EPF has to make up the funding shortage to MR (if any), which is mainly caused by its investment strategy different from that of GPIF.

Outline of AIJ scandal

- ✓ February 24: Financial Services Agency (FSA) imposed the following administrative punishment on AIJ Investment Advisors CO.,LTD.(AIJ)
  - Business suspension order (from 24 February to 23 March)
  - Business improvement order
    - comply with Securities and Exchange Surveillance Commission (SESC)'s inspection
    - assess clients' assets
    - do not expense company asset without due course
    - report above results to FSA until 23 March
- ✓ March 23: FSA imposed the following administrative punishment on AIJ
  - Discharge of registration of AIJ as an investment advisory firm
  - Business improvement order
    - explain properly about the administrative punishment to its clients
    - cooperate on the activities to maintain the clients' assets in accord with the clients' intents
    - provide its clients timely and properly with the information necessary to maintain the clients' assets

    etc.

Outline of AIJ scandal

- ✓ SESC recommended FSA for the administrative punishment on AIJ on March 22

Violation of Financial Instruments and Exchange Law found by SESC's inspection

- Providing potential clients with false reports in the net asset value of "AIM Global Fund" and its sub-funds, conducted by its president, in its sales activities aiming at making Discretionary Management Contracts
- Providing its clients with false investment performance reports
- Submitting false business reports to Kanto regional financial bureau
- Violation of the fiduciary duty of loyalty (ex. payments based on purported returns to existing investors from funds contributed by new investors)

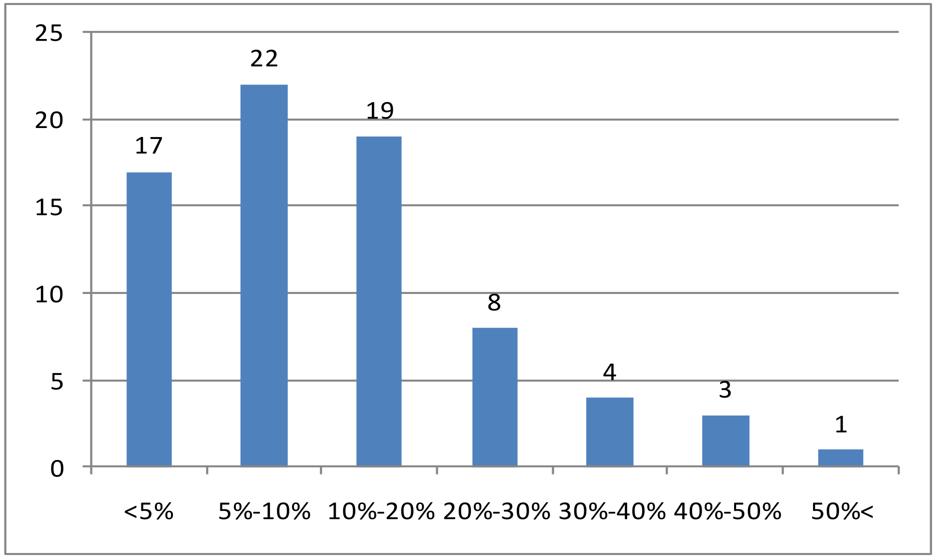
- ✓ SESC accused 3 persons, including Mr. Asakawa, the president of AIJ, on July 9, 30, September 19, and October 5 of above frauds.

- ✓ In response to SESC's accusations, The Tokyo District Public Prosecutors Office prosecuted them. The court proceedings started on December 5.

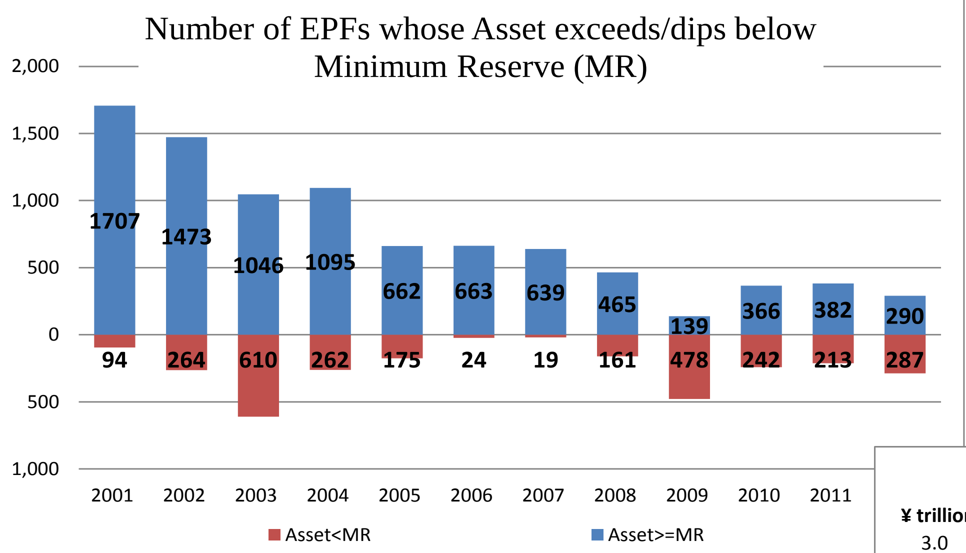
AIJ's major clients were pension funds

- ✓ 84 pension funds invested \186bil. (US\2.3bil.) to AIJ's investment funds
- ✓ 74 funds are Employees Pension Funds (EPFs), 10 funds are Defined Benefit Corporate Pensions (DBPs)
- ✓ 73 of the 74 EPFs are Multiemployer EPFs

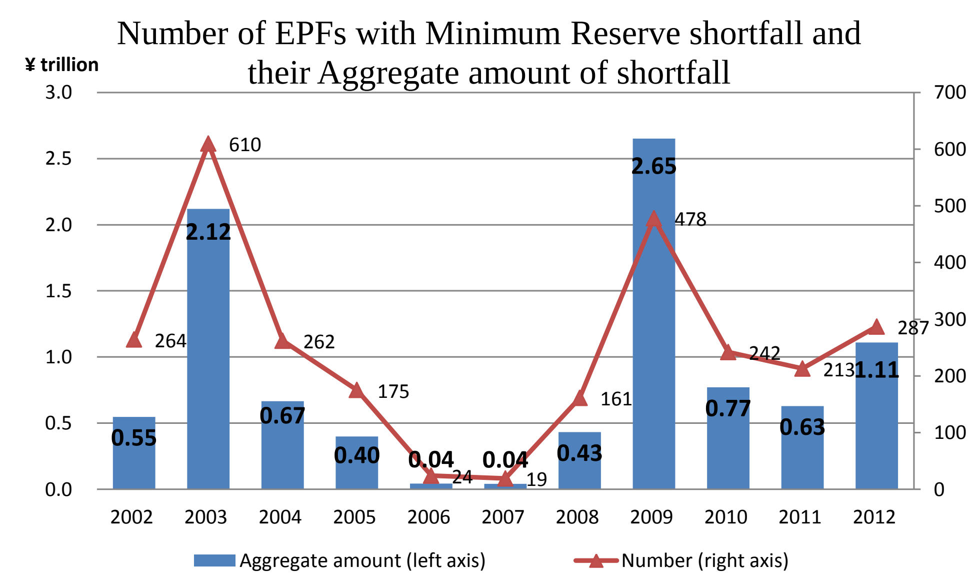
Number of EPFs by ratio of AIJ's fund to their total assets



Minimum Reserve Shortfall



Source: Ministry of Health, Labor and Welfare



Source: Ministry of Health, Labor and Welfare

Government's advisory committee

Pension Bureau of Ministry of Health, Labor and Welfare (MHLW) organized the advisory committee in April to consider the investment and financial issues of EPFs etc.

Main Agenda of the committee

- Regulations regarding Pension Fund Investment
  - Fiduciary duty (diversified investment, duty of care, duty of loyalty)
  - Decision making structure (quality, process, use of consultants, relation between money managers and custodians, disclosure, etc.)
  - Internal audit and supervision
- Financial Issues of Pension funds
  - Setting discount rate, and how to cope with funding shortfall
  - Criteria on benefit reduction and plan termination
- EPF's future
  - Significance of Substitution scheme
  - How to cope with Minimum Reserve shortages
  - Multiemployer EPF and pension policy for SMEs

Government's advisory committee

- ✓ The advisory committee issued a report on July 6.
- ✓ Regarding the third agenda (EPF's future), the report pointed out that there were two conflicting views.

EPF scheme causes the risk for EPI by the possibility of funding shortfall to Minimum Reserve. So the scheme should be abolished sometime in the future.

EPF scheme has played its important function in spreading pension plans among SMEs. So the scheme should be maintained.

- ✓ On September 28, Ministry's working team, headed by Vice Minister, announced its policy to abolish the EPF scheme in the future. It also announced its plan to organize an "expert committee" in the Pension Council.

The "expert committee"

- ✓ The first meeting of the committee was held on November 2.
- ✓ MHLW proposed a plan, which includes the following proposals.

How to cope with the funding shortfall to Minimum Reserve

- ➢ Easing the obligation to make up the funding shortfall by setting some limit, while pressing financially distressed EPFs to terminate
- ➢ Abolishment of the Joint Obligation in the case of plan termination of multiemployer EPFs with Minimum Reserve shortfalls

Proposals for sustainable pension plans

- ➢ Easing regulations on plan design (such as adding an option to the interest credit rates in CB plan, and introducing a collectively managed DC plan)
- ➢ Measures to encourage the shift from EPFs to pension plans of other types

Examining the substitution scheme in EPF

- ➢ Fine-tuning the definition of the Minimum Reserve, which has an effect of lowering the MR
- ➢ Two step process to abolish the scheme; first to encourage termination for EPFs with MR shortfalls, and shift to other pension plans for EPFs without MR shortfalls in the first 5 years; then enforce to stop exempt premiums and future accruals and to implement "Daiko-Henjo" or to terminate the plan in the next five years

The future of occupational pensions in Japan

- ✓ Although the total amount of individual financial assets in Japan exceed 3 times of the GDP, private pension assets are much less than those of many western countries.
- ✓ Given the growing percentage of non regular workers and the gradual decrement of the level of public pensions, coverage would be a major potential issue for the future occupational pension policy.
- ✓ In contrast to US and UK, defined benefit plans still dominate the occupational pension field. Part of the reason might be attributed to its flexible criteria, such as the criteria for benefit reductions.
- ✓ Even in occupational pensions, the advance consensus formation regarding the ex-post redistribution among related parties, such as active participants, retirees, and plan sponsor(s), might be essential for sustainable pensions.
- ✓ Discussion of EPF's future should be based on the accurate fact-findings. In my opinion, an appropriate "maintenance and repair" will be much more efficient than the "scrap-and-build".

Thank you for your attention!

Any comments will be greatly appreciated.