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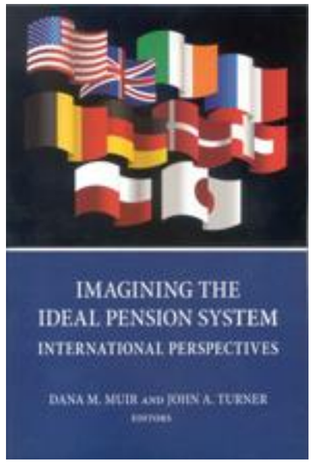

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International Perspectives

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John A. Turner
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How to Establish a Better Corporate Pension System in Japan

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BACKGROUND

In 2010, Japan had 22,219 private sector companies that had been in operation for more than 100 years, the largest number of any country. Of these, 39 companies had been in operation for at least 500 years, 435 companies for at least 300 years, and 1,191 companies for at least 200 years. The Kongou-Gumi Company, the oldest continuously operating company in Japan, was established in the year 578 as a construction company of temples and shrines.

There are two primary reasons that so many companies have been able to remain in operation for so long in Japan: 1) Japanese companies have traditionally respected *Wa* (harmony) more than profits not only with their customers, but also with society and their employees, and 2) according to historical documents, they established severance lump-sum payment systems for the highly paid staff beginning in the seventeenth century. Because of these two features, they have been able to overcome many economic, social, and technological changes and have enjoyed long prosperity.

Following the Meiji Revolution in 1868, the Japanese government opened Japan to the western world. Along with many other concepts, ideas about western corporate systems and corporate pension systems were introduced. The Kanebou Cotton Spinning Company voluntarily established the first western-style occupational pension plan in Japan in 1905. Soon after, the Mitsui Company, a trading company, and many other companies established pension plans for highly paid and middle-income employees.

Development of Defined Benefit and Defined Contribution Plans

In 1962, the corporate tax law and income tax law were amended, and the Tax-Qualified Pension (TQP) Plan was introduced to provide defined benefit plans to employees. Many large- and mid-sized employers changed all or some of their pension contributions from the severance lump-sum payment system to a TQP plan, which is a corporate pension contract between employers and financial companies. To receive favorable tax treatment, the content of the TQP contract must be approved by the Commissioner of the National Tax Agency.

The postwar period of high inflation decreased the real value of pension benefits of the Employees' Pension Insurance (EPI), which is Japan's social security plan. Therefore, in 1965, the Employees' Pension Fund (EPF) plan was established by amendment of the EPI law to allow employers to increase pension benefits. In 1967, the Employees' Pension Fund Association (EPFA) was also established.

Because the increase in EPF plan benefits increased costs for employers, sponsoring employers and their employees are exempted from paying a portion of EPI plan contributions to the government, and instead pay them to their EPF plan. The EPF plans also provide additional benefits on top of the portion that replaces EPI (social security) benefits.

Compared with the TQP, EPF plans have received more favorable tax treatment because EPF plans act as a substitute for part of the EPI. EPF plans were mainly established by large employers (1,000 or more employees) to provide lifetime benefits. TQP plans were mainly established by medium and small employers, typically paying benefits for a limited number of years. Many employers that hoped to establish higher quality employee benefit systems established both plans, each of which is a defined benefit plan that played a major role in providing retirement income for private sector employees until 2001.

As of April 2011, Japan had not enacted a basic corporate pension law establishing fiduciary responsibility, such as ERISA in the United States and *Die Alter Renten Gesetz* in Germany. Because of the collapse of Japan's "bubble" economy in the 1990s and changes in the Japanese economy resulting from changing world economic conditions, however, the New Corporate Pension Amendment was established in 2001, which amended the EPF and TQP systems, which had huge deficits (20 trillion Japanese yen [¥]). In addition, the Defined Benefit Corporate Pension Law and the Defined Contribution Pension Law, the first law governing defined contributions in Japan, were enacted. Before the 2001 laws, many pension scholars had recommended the development of defined contribution plans, using terms such as “self responsibility,” but the recommendations did not include full disclosure of the financial risks associated with these types of plans. The Employers’ Association and the Conservative government at the time accepted this idea, and the Confederation of Labor did not oppose it, so the new laws were enacted.

Although the defined contribution plans were necessary, the laws regulating them suffered from several weaknesses because they were enacted too early with too few protections. The weaknesses included the following:

- Defined contribution plans should be marketed and managed under strict fiduciary responsibility, but there were no such regulations in the basic corporate pension act.
- Defined contribution plans require fair and transparent financial markets—the financial markets in Japan are neither fair nor transparent, and many financial organizations have sustained large losses or declared bankruptcy.
- Defined contribution plans require enhanced tax regulations and accounting rules, but these were not established.
- Participants of defined contribution plans need to receive financial information and education, but these types of information and education were never provided.
- The act does not contribute to retirement income security for participants—it only helps employers decrease costs and financial corporations increase gains.

In this reform, EPF plans were allowed to stop acting as a substitute or replacement for the EPI plan by returning the corresponding EPF money that would have been paid into the EPI plan to the government. No new TQP contracts were allowed after April 2002. Existing TQPs had to be converted to another form of occupational pension by the end of March 2012 because they would no longer receive favorable tax treatment starting in April 2012. In March 2001, TQPs had 9.9 million members and assets of ¥22.3 trillion. The government intended to change TQPs to another type of corporate pension because of the huge deficits and weaker economy. Because there are no pension benefit guarantees for TQPs, it is not clear whether these participants will receive another corporate pension in the current weaker economy.

With these reforms, corporate and personal defined contribution plans were first introduced in Japan. Employees who have no occupational pension plan from their employer can establish a personal defined contribution plan using their own contributions.

CURRENT SOCIAL SECURITY AND CORPORATE PENSION SYSTEMS

Social Security

The National Pension Insurance (NPI) is a flat-rate pension that is part of the Japanese social security system. Self-employed, "non-regular" employees (e.g., part-time or temporary workers), unemployed, and nonworking spouses of insured workers in the earnings-related public pensions (the EPI in the private sector and the Mutual Aid Associations' Pension Insurance [MAAPI] in the public sector) pay a fixed monthly contribution (¥15,020 in 2011, increasing to ¥16,900 in 2017) to the NPI and receive a fixed monthly pension benefit (¥65,741 with 40 years of contributions as of 2017) starting at 65 years of age. In addition to the NPI, employees in the private and public sectors participate in the earnings-related EPI and MAAPI, respectively.

Corporate Pension System

In the private sector, the Japanese pension system is composed of defined benefit and defined contribution pensions. The defined benefit corporate pensions are the EPF plans, the defined benefit corporate pension plans (established by the 2001 law), and the soon-to-be-discontinued TQP plans. As discussed previously, the 2001 reform also introduced corporate and personal defined contribution pension plans.

The composition of pension plans has shifted tremendously in the past decade. The occupational pension system had its largest amount of assets, ¥63.3 trillion (present value), at the end of March 1998. The EPF system had 1,884 plans, 12.2 million participants, and pension fund assets of ¥44.9 trillion. The TQP system had 90,243 plans, 10.6 million participants, and pension fund assets of ¥18.4 trillion. By the end of March 2010, however, the EPF system only had 608 plans (a 67.7 percent decline), 4.6 million participants (a 62.3 percent decline), and pension fund assets of ¥29.0 trillion (a 35.4 percent decline). The TQP system had 17,184 plans (an 81.0 percent decline), 2.5 million participants (a 76.4 percent decline), and pension fund assets of ¥6.4 trillion (a 65.2 percent decline).

The corporate defined benefit system, which did not even exist in the late 1990s, had 7,405 plans, 6.5 million participants, and pension fund assets of ¥39.0 trillion at the end of March 2010. At the same time, corporate defined contribution plans had 13,222 plans, 3.6 million participants, but incomplete pension fund asset information was available. Personal defined contribution plans had only 0.1 million participants, and pension fund information was also not available. At the end of March 2008, however, the total fund amount for corporate and personal defined contribution plans was only ¥3.7 trillion.

According to official statistics as of the end of March 2010, the number of participants in all defined benefit plans (EPF, TQP, and corporate defined benefit) decreased from 22.8 million at the end of March 1998 to 13.6 million (40.4 percent decline). Pension fund assets increased slowly from ¥63.3 trillion at the end of March 1998 to ¥74.4 trillion (17.5 percent increase), and per participant pension fund assets increased from ¥2.8 million to ¥5.5 million. The total number of participants of corporate and personal defined contribution plans was 3.5 million, fund assets totaled ¥3.9 trillion, and the per participant fund amount was ¥1.1 million. At the end of March 2007, the average monthly contribution was ¥11,400.

This means that small- and mid-sized employers have quit offering defined benefit plans and that almost all employees working for these companies are not covered by any type of pension, whether defined benefit or defined contribution.

Only employees of large companies and good mid-sized companies have sustainable pensions with good benefits. Many employees in large companies have not only a variety of defined benefit plans but also corporate defined contribution plans.

Because of the recent unstable financial markets and weak earning power of financial institutions, corporate pension funds suffered average investment losses of 9.8 percent in FY2007 and 17.2 percent in FY2008. They gained 13.8 percent in FY2009, but lost 6.2 percent in April–August FY2010.

Because of the weak economy, underfunding of corporate pensions increased to ¥13 trillion as of March 2009, and it was no doubt even higher in March 2010. A government accounting committee has discussed strengthening regulations for reporting unfunded liabilities on the balance sheet of employers beginning in 2012.

Many employers with underfunded pension plans have gone bankrupt. In September 2010, Japan Air Line Co. Ltd (JAL) reorganized under the Corporate Reorganization Act with the infusion of ¥350 billion of public money, a debt waiver of ¥522 billion (87.5 percent) by financial corporations, and personnel reductions of 16,000 employees (19.3 percent). Prior to the reorganization, former employees had been receiving EPF, TQP, corporate defined benefit, and corporate defined contribution plans with total pension benefits of more than ¥200,000 per month after retirement.

But JAL had a huge underfunded liability of ¥331.4 billion for its corporate pension plans as of March 2010. Unlike the EPF pension plans, the TQP and corporate defined benefit plans have no pension benefit guarantee system. After difficult negotiations, the decision was made to cut future benefits of active employees by 53 percent with the required consent of at least two-thirds of employees and to cut benefits to current beneficiaries by 30 percent with the required consent of at least two-thirds of beneficiaries.

The Board of Directors of JAL's pension funds has an equal number of members representing the employer, active employees, and beneficiaries. The board maintained a projected investment return rate of 4.5 percent even in the recent period when a more reasonable long-term rate would have been 1.0 percent. They did not adequately perform their fiduciary duties, but no pension law clearly establishes strict pension fiduciary responsibility in Japan.

CURRENT PENSION CONDITIONS

Establishing a better, sustainable retirement income security system is one of the biggest political and social problems in Japan. This better and sustainable system should be established harmoniously as a three-pillar retirement income system: a public pension system (first pillar), corporate pension systems (second pillar), and individual financial products (third pillar). The focus here is primarily on the structure and poor governance of the second pillar.

The OECD (2009) reported that “private pensions are an important part of retirement-income provision in Japan, covering 45 percent of the workforce.” According to the official employment report, the number of active workers in Japan was 62.7 million in July 2010, and the unemployment rate was 5.2 percent. In 2009, the number of active nonfarm workers totaled 49.1 million, excluding 5.0 million public sector employees. Participants of all corporate pension plans numbered 17.2 million at the end of March 2009, or 35.0 percent of active nonfarm workers. The coverage rate of 45 percent in the OECD report may have been correct in 1998, but it certainly is incorrect in 2009 and later.

Because of the weaker economy and the cost-oriented employment policy in Japan, the use of non-regular employees (i.e., part-time or temporary workers) has been increasing. The number of non-regular workers increased from 8.7 million in 1990 to 16.9 million in 2010. Over one-third of the workforce is now considered to be non-regular. At the same time, the number of regular workers decreased from 34.7 million to 33.3 million, mainly because of the weaker economy.

According to Ministry of Health, Labor, and Welfare statistics, the average monthly earnings of regular male employees in 2008 was ¥345,300 compared with ¥224,000 for non-regular employees. The average for women was ¥243,900 for regular workers and ¥170,500 for non-regular workers. Contrary to the basic principles of equal opportunity and treatment, part-time employees cannot participate in earnings-related EPI plans or other corporate pension plans, only in the flat-rate NPI plan. As a result of an amendment of the labor law in 2006, companies can employ non-regular employees for up to three years.

According to a survey on people’s knowledge of financial matters conducted by the Bank of Japan in 2008, 71.8 percent of people said that they have little knowledge about stocks and bonds; only 4.9 percent answered that they have sufficient knowledge about stocks and bonds. Approximately 83.6 percent of those surveyed answered that they have not heard about defined contribution plans (50.8 percent) or have heard about them but do not know what they are (32.8 percent). It is clear that seven years after the Corporate Pension Reform in 2001, the government, financial organizations, and employers had not done a good job informing people about defined contribution plans.

In September 2010, the government and the Japan Pension Service revealed that the Japan Pension Service had mismanaged basic data, including the name, date of birth, basic salary, and years of membership, to the extent that about 2.6 million EPF members are at risk of losing at least part of their EPF benefits.

NECESSARY POLICY CHANGES

The Japanese corporate pension system has many fundamental problems. The following sections examine policies that should be established to address these problems.

General Reforms

In general, employers and employees need to understand that the harmonization of corporate profits and the employee welfare system is necessary. Employers, in particular, need to exercise corporate responsibility and develop a better employee welfare system, particularly with respect to their corporate pension plans in Japan's current aging society.

In political terms, pension regulations are quite complicated and cause management inefficiencies in the huge social security and corporate pension funds in Japan. Many high-ranking pension-related governmental staff members take high-ranking positions with financial institutions or financial-related corporations after their retirement, which increases the political risks for the retirement income system in Japan. It is a main reason why pension policies are not fair, transparent, or efficient as compared with western countries. New laws should be enacted to regulate the movement of former high-ranking pension bureaucrats into high-paying jobs in related financial fields.

The government in Japan has established many committees, particularly in the pension field. Pension scholars are generally eager to be members of the committees because they can gain access to detailed government information and are well paid. Newspapers have reported that members of these committees are paid from ¥4 to 17 million to attend 5 to 10 meetings a year. The Salary Act enacted in 1949 regulates the salaries of some members of government committees, and the limit in 2011 was ¥936,000. Some scholars are members of several committees, so the work is very lucrative. Members of these committees generally accept policy proposals from bureaucrats with little opposition—they are really nothing more than well-paid "shadow bureaucrats" and are not independent from the government. Pension policymaking in general could be strengthened by strictly and reasonably regulating the pay structure of government committees.

In the labor field, we should observe the basic principles of the International Labour Organization (ILO 1951) concerning equal opportunity and treatment and amend related laws to strictly regulate salaries for similar types of labor.

Reforms in the Corporate Pension System

Several reforms need to be made in the corporate pension system.

- A minimum mandatory corporate pension system should be established to supplement the earning-related social security pension system and establish a better and more stable retirement income security system.
- A Basic Corporate Pension Act should be enacted to include enhanced fiduciary responsibilities and a pension benefits guarantee system.
- Taxation of pension investment income should be abolished.
- To improve accounting regulations, rules from the International Financial Reporting Standards and the Financial Accounting Standards Board should be introduced in Japan, particularly present value accounting.

- To improve financial gains, the financial markets should be reformed to become more transparent and more efficient. Financial corporations should establish higher profit-gaining powers and lower fee structures.
- The government, financial corporations, and employers should provide more and better financial information and education to employees and the general public.

CONCLUSION

Japanese corporate pension policy has not been successful in terms of coverage or creating a sustainable pension system. There has been a focus on small technical subjects and a general neglect of basic problems in Japan's aging society in the twenty-first century.

Employers and employees need to understand the importance of better and more stable employee welfare systems, particularly regarding corporate pension plans, as a way of increasing corporate profits and supporting the social security pension system. The social security and other pension systems need to be reviewed and restructured with a mutual understanding of the importance of public and corporate pension governance and to establish fair, transparent, and efficient markets and regulations in pension-related fields. An ongoing evaluation of policies, government agencies, pension funds, and financial corporations should be conducted to ensure excellent performance.

Japan should return to a basic guiding principle—there should be no long-term development of a company without a stable employee welfare system, particularly in terms of corporate pension plans in the twenty-first century.

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