

Characteristics and trend of severance and retirement benefits in Japan

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Summary

In Japan, before the introduction of tax-qualified pension plans (TQPPs) in 1962, almost all of severance and retirement benefits sponsored by corporations were paid by lump-sum, which were not funded outside of the companies. After the introduction of TQPPs and employees pension funds (EPFs), book-reserved lump-sum benefits were partly or wholly converted to funded benefits. All of these lump-sum and pension benefits were DB type in the last century.

When DC and hybrid plans were introduced in the beginning of this century, many people said that DB type would be changed to DC or hybrid type. But many companies have made enormous efforts not to change DB type benefits. And it seems they would like to maintain the same structure in the future.

But accounting standards have huge influence on post-employment benefits. And if the immediate recognition of actuarial gains and losses is required in the future, it may kill DB type plans. In order to alleviate the influence, I think the definition of obligation should be reconsidered.

Key words

DB type benefit system, DC plans, Accounting standards, Immediate recognition of actuarial gains and losses

1. Brief History of the Employee Benefit Arrangements

1.1 Development of the Lump-sum benefits

In the Japanese private sector, the practice of providing a lump-sum payment at severance or retirement became fairly common by the early 20th century. It contributed to the reduction of labor disputes associated with layoffs; and it also played an important role in providing means of support for the unemployed and post-retirement life.

Favorable tax treatment for lump-sum benefits was granted in 1952, for plans that met certain requirements. To qualify for this favorable treatment, a plan had to be based on a formal written instrument such as a labor agreement or company regulations. If qualified, the increase in the book-reserved account for lump-sum was deductible as tax expenses, with some limitations. With this favorable treatment, lump-sum payment system became more popular. And all lump-sum benefits were DB type.

1.2 Introduction of Tax Qualified Pension Plans

Under the tax law effective at the time, if a plan's assets were managed by outside financial institutions, the employer's contributions were considered employee income and subject to income tax, while this was not the case if the assets were managed in-house. In response to strong appeals made by employers, the taxation system was reformed in 1962 and a special treatment was accorded to DB type corporate pension plans.

These pension plans are called Tax Qualified Pension Plans (TQPPs).

By adopting the TQPPs, many employers partly or wholly converted their book-reserved lump-sum benefits to funded pension benefits.

1.3 Introduction of Employees' Pension Fund Schemes

The public pension system for workers in private sector is the Employees' Pension Insurance (EPI). It comprised of two parts, namely fixed amount benefits and benefits payable in proportion to wages.

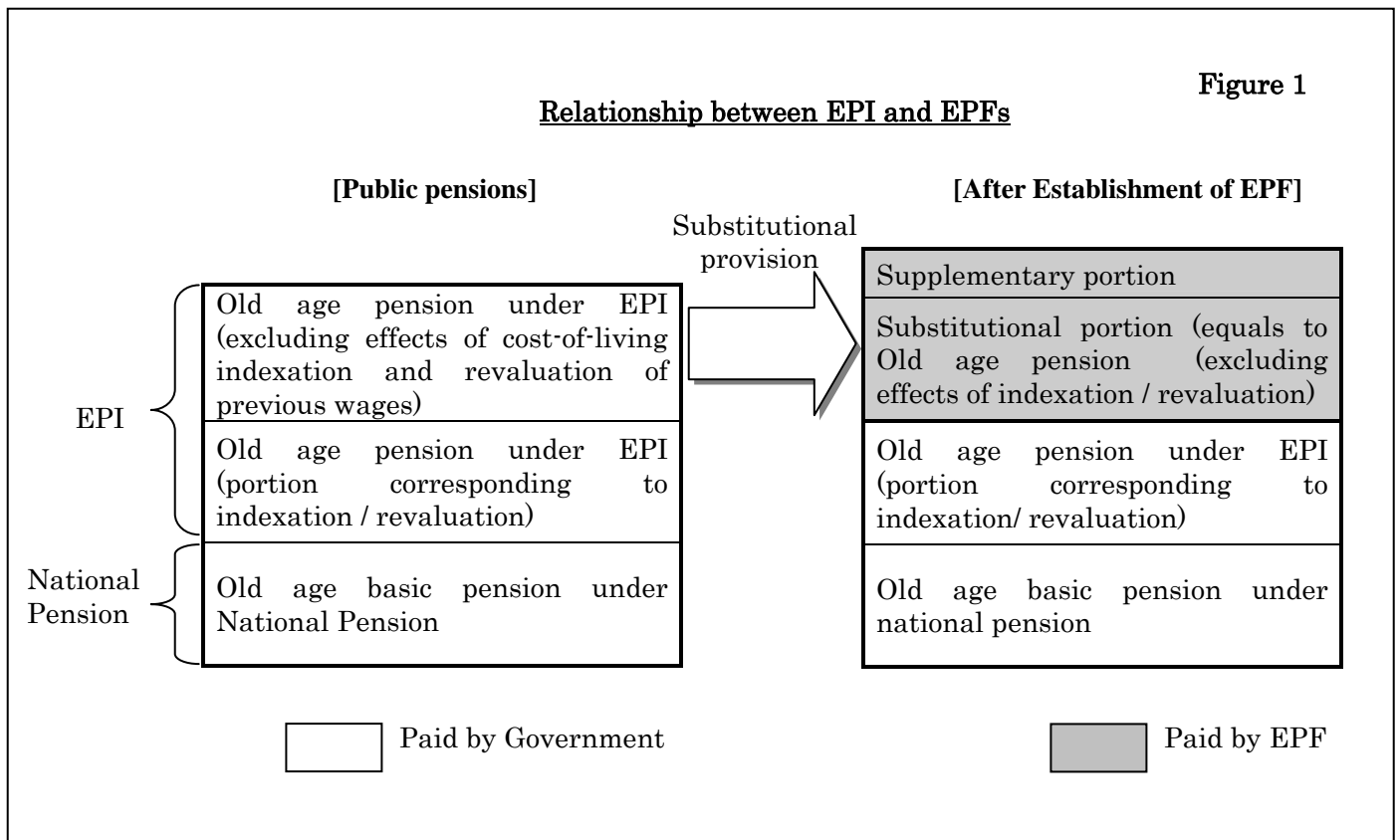
In 1965, the EPI was amended and an Employees' Pension Fund (EPF) scheme modeled after the British system was introduced that replaced earnings-related old age pension benefits payable by the EPI. In short, EPFs were to assume responsibility for providing substitutional earnings-related old age pensions that would otherwise have to be paid through the EPI. An employer who has established an EPF pays part of

social security contribution into the EPF, instead of to the EPI. This part is called “exemption contribution.”

In addition to the substitutional portions, EPFs are required to have supplementary portions. Both substitutional portion and supplementary portion have to be DB type. And main parts of supplementary portions were usually designed by the conversion of lump-sum benefits, like TQPPs.

The significance of the substitutional portion to the entire EPF varies. In some plans, the substitutional portion may account for as little as 30 percent of the total benefit while in others it may account for as much as 90 percent of the total benefit.

After several amendment of EPI, the current relationship between EPI and EPFs is shown as below.



There are three types of EPFs: 1) Single-Employer Funds established by a single employer, 2) Allied-Employer Funds established by affiliated employers within a group of businesses, and 3) Multi-Employer Funds established by an association of many companies joined together under certain conditions (e.g., a particular type of trade or

region) as plan sponsors. The minimum size of covered employees is specified for each type of EPF to ensure the fund's stability: specifically, over 1,000 for Single-Employer Funds and Allied-Employer Funds, and over 5,000 for Multi-Employer Funds.

1.4 Structural Reform of Corporate Pension Schemes

In June 2001, both the Defined Contribution Pension Act (DCPA) and the Defined Benefit Corporate Pension Act (DBPA) were enacted to mainly satisfy employers' appeals.

The purpose of the DCPA is to introduce defined contribution pension plans as a new option for retirement income security.

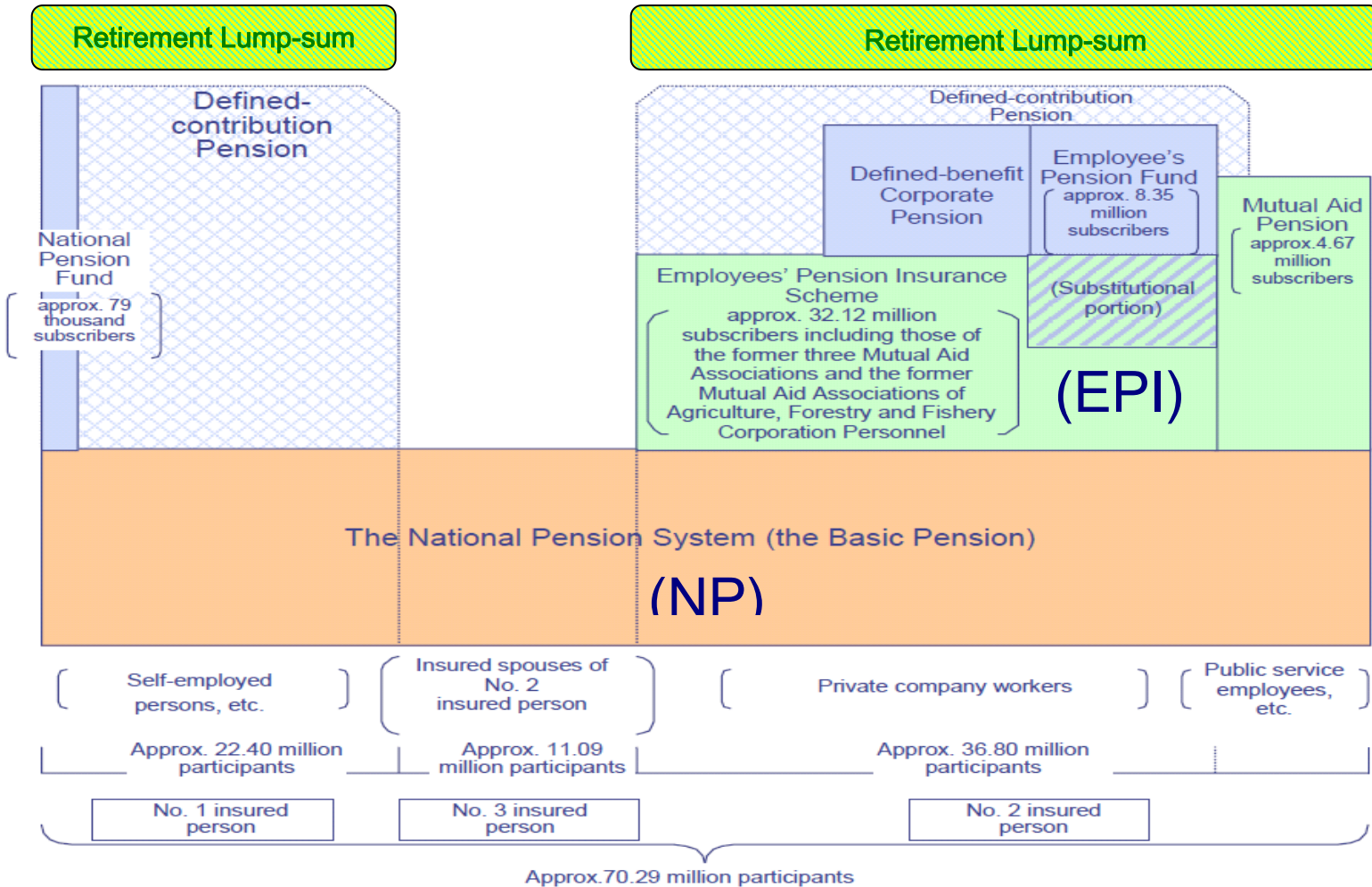
One major purpose of the DBPA is to introduce a common framework to protect employees' benefit rights covered by defined benefit corporate pension plans: both EPFs and Defined Benefit Corporate Pension Plans. The act provides (1) funding requirements, (2) fiduciary responsibility, and (3) reporting and disclosure (and in conjunction with this, the TQPPs, which provides inadequate funding requirement, will be abolished by the end of March 2012).

At the same time, EPI was amended to permit each EPF to separate the substitutional portion and transfer the obligation and related assets to the government (so-called "Daiko-henjo"). The remaining portion (that is, the Supplementary portion) continues to exist exclusively as a Defined Benefit Corporate Pension Plan (DBCPP).

Current Overview of the Retirement Benefits System is shown in the figure 2.

Overview of the Retirement Benefits System in Japan

Figure 2



(As of 31 March, 2004)

2. Common benefit formulas

2.1 An example of severance and retirement lump-sum

The amount of lump-sum is usually determined by the negotiation between employer and employees.

One typical traditional final pay related lump-sum amount is calculated as follows:

$$\text{Lump-sum amount} = \frac{\text{Final monthly salary}}{\text{The rate in the table 1 specified according to the employee's length of service and reason for resignation}}$$

An example of rates for lump-sum

Table 1

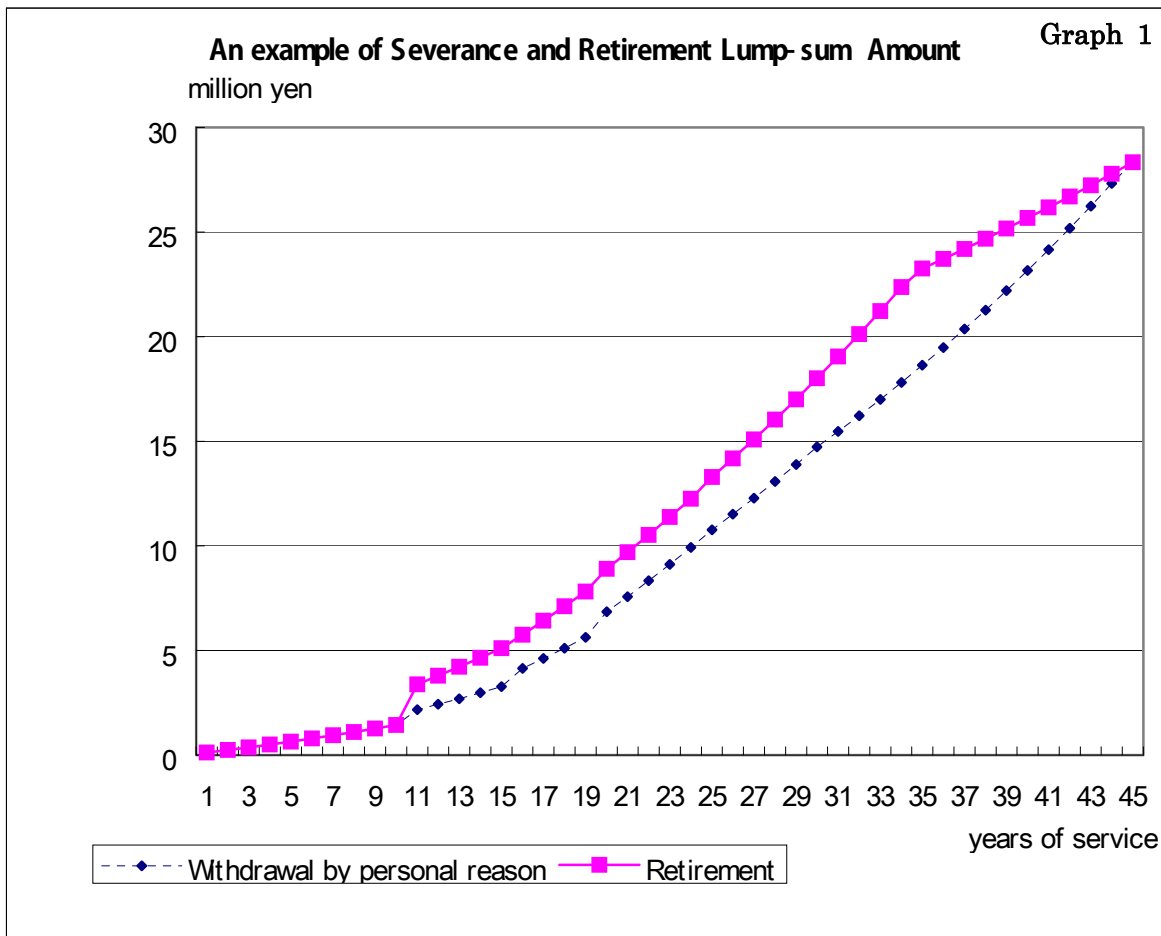
Years of service	Reason for resignation		Years of service	Reason for resignation	
	Withdrawal by personal reason	Retirement		Withdrawal by personal reason	Retirement
1	0.600	0.600	24	31.500	38.870
2	1.200	1.200	25	33.500	41.340
3	1.800	1.800	26	35.100	43.212
4	2.400	2.400	27	36.700	45.084
5	3.000	3.000	28	38.300	46.956
6	3.600	3.600	29	39.900	48.828
7	4.200	4.200	30	41.500	50.700
8	4.800	4.800	31	42.700	52.572
9	5.400	5.400	32	43.900	54.444
10	6.000	6.000	33	45.100	56.316
11	8.880	13.875	34	46.300	58.188
12	9.760	15.250	35	47.500	59.280
13	10.640	16.625	36	48.700	59.280
14	11.520	18.000	37	49.900	59.280
15	12.400	19.375	38	51.100	59.280
16	15.390	21.375	39	52.300	59.280
17	16.830	23.375	40	53.500	59.280
18	18.270	25.375	41	54.700	59.280
19	19.710	27.375	42	55.900	59.280
20	23.500	30.550	43	57.100	59.280
21	25.500	32.630	44	58.300	59.280
22	27.500	34.710	45	59.280	59.280
23	29.500	36.790			

Please note that “Retirement” means that an employee quits by reaching normal

retirement age (usually age 60), which is stipulated in work regulation set by employer.

It is common that the lump-sum for withdrawal by personal reason is less than that for retirement.

The model of lump-sum for this example is shown in graph 1.



It is very common that the graph of Japanese lump-sum is S-shaped as shown in the graph above.

2.2 An example of TQPP

As explained in 1.2, by adopting the TQPPs, many employers partly or wholly converted their book-reserved lump-sum benefits to funded pension benefits.

As the main benefit of TQPP is pension, employer has to determine the amount of annuity for retirees. The most common way to convert lump-sum into annuity is that to

determine the pension amount in order to equalize the present value of annuity with the lump-sum amount. Usually, the assumed interest for calculating present value is the same rate that is used to calculate the contribution rate, which was traditionally fixed at 5.5% per annum.

One of common eligibilities for pension benefit is the set of following 3 conditions.

1. Resignation with 20 or more years of service.
2. Attain the age 60.
3. The pension benefits will be paid for 10 years. (If the pension recipient dies in less than 10 years from the first payment, survivor will receive the remaining present value of pension. That is, the pension is equivalent to 10 years certain.)

When the employer, which has the lump-sum benefits described in 2.1, wholly converts its benefits to TQPP under this design, the yearly pension amount is calculated as follows:

$$\begin{aligned} \text{Yearly pension amount} &= \text{Final monthly salary} \times \text{The rate in the table 1 specified according to the employee's length of service and reason for resignation} \\ &\quad \times \text{The rate in the table 2 specified according to the employee's age at resignation} \end{aligned}$$

Table 2
An example of rates for pension

Age at Resignation	Rate	Age at Resignation	Rate
35	0.496	48	0.248
36	0.470	49	0.235
37	0.446	50	0.223
38	0.423	51	0.211
39	0.401	52	0.200
40	0.380	53	0.190
41	0.360	54	0.180
42	0.341	55	0.170
43	0.324	56	0.162
44	0.307	57	0.153
45	0.291	58	0.145
46	0.276	59	0.138
47	0.261	60	0.131

In this case, the interest rate used for conversion is 5.5% per annum. Such interest rate is called conversion rate.

An employee who resigns with 20 or more years of service (that is he/she is eligible for pension when he/she attains age 60) can elect to receive a lump-sum payment equivalent to present value of pension in lieu of the annuity, provided he/she satisfies certain reason. That means employee can receive the same amount of lump-sum as before the introduction of TQPP.

And under TQPP with this design, employees who resign with less than 20 years of service are eligible to receive the lump-sum benefit equal to that described in 2.1.

From the employees' viewpoint, the benefit at the resignation was not changed by the introduction of TQPP. Change was only the preparation of payment by the company, namely internally book-reserved or externally funded.

Some employers converted the lump-sum benefits to TQPPs only for the employees who retire by reaching normal retirement age. And companies continued to pay lump-sum benefits from their book-reserved account for employees who withdraw younger than the normal retirement age or die in service. By adopting such TQPPs, the tax favorable treatment for the book-reserved account for lump-sum remained unchanged, and at the same time, employers' contributions to TQPPs were also deductible as tax expenses. That means employers could doubly enjoy the favorable tax treatment. Such plan design is not permitted for EPFs or DBCPPs.

2.3 An example of EPF

Benefit from substitutional portion is the same as the old age pension under EPI (excluding effects of cost-of-living indexation and revaluation of previous wages).

Supplementary portion is usually divided into 2 parts.

The first part is designed, for example, to be 1% of the substitutional portion's benefit, which is not of great significance.

The second part is designed like TQPP described above, which has the great weight in benefits. And this part is called additional portion.

Pension benefits of additional portion are required to be paid for life, while TQPP is permitted to provide pensions for certain years (for example 10 years).

In designing the additional portion, it is very common to make guaranteed period for

pension benefits. And employers usually make the present value of the pension benefits for guaranteed period equivalent to the converted lump-sum.

In this way, if the employer that has the lump-sum benefits described in 2.1, wholly convert its benefits to additional portion with 10 years guarantee of pension, the pension amount will be the same as stated in 2.2.

The difference is the period of pension. Many pensions by TQPPs cease after certain (for example 10) years. But additional portion of EPFs continues to pay pensions as long as the recipients live. That means EPF is very favorable for employees.

Like TQPP, the employee who resigned with long enough years service to be eligible for pension can elect in lieu of the annuity to receive a lump-sum payment equivalent to present value of pension for guaranteed period, provided he/she satisfies certain reason.

In EPF usually more employees prefer pension to optional lump-sum, compared to the TQPP, because they can receive pension as long as they live. But due to the favorable treatment in income tax, some employees choose optional lump-sum, which leads to forfeiture of their safety net for longevity.

2.4 Cash Balance Plan

When the DBPA was enacted in June 2001, EPFs and newly born DBCPPs were permitted to design their benefits by Cash Balance Plans (CBPs). CBP defines the promised employee benefit by reference to a notional account balance (NAC). An employee's notional account balance is increased with periodic notional principal credits and notional fixed and/or variable interest credit. Upon resignation usually with more than 3 years of service, the employee is entitled to the lump-sum amount of his/her NAC.

In CBP, conversion rate from a lump-sum benefit to a pension benefit can vary according to the move of government bond rate, even after the commencement of annuity. That means when bond rate goes up, pension amount increases, and when bond rate goes down, pension amount can be decreased legally.

Japanese CBP was introduced to mainly satisfy employer's appeals, which claimed that the systematic fluctuation of pension benefits without consent of each beneficiary should be allowed according to the market condition.

CBPs are not allowed for TQPPs, because they are scheduled to vanish by March 31,

2012.

2.5 Quasi Cash Balance Plan

By introducing CBPs, pension plans became able to alter the pension amount according to market rate. But under CBP, not only the pension benefits but also the lump-sum benefits must fluctuate according to bond rate. Fluctuation of lump-sum remained as obstacle to adopt new plans, because Japanese are not familiar with the lump-sum benefits that are not calculated by the traditional defined benefit formula.¹

To move more smoothly to the condition that allows employers to alter the pension amount according to market, new type plan, which can be named Quasi Cash Balance Plans (QCBPs), were permitted for EPFs and DBCPPs, by deregulation in May 2003.

By adopting QCBP, while lump-sum amount for employee is calculated by traditional pattern, that means market change does not affect the lump-sum amount, but pension amount alters according to market without beneficiary's consent.

Only by changing into QCBP, structure of the lump-sum benefits is usually not affected. As a matter of fact, if an employee eligible for pension in QCBP retires, and he/she select to receive optional lump-sum instead of pension, he/she will receive lump-sum which is equal to the amount that would be paid under the former plan. For these lump-sum benefits, both employers and employees usually see them as DB plans, although DBCPPs have new type of benefit formulas for pensions.

3. Trend of benefit systems

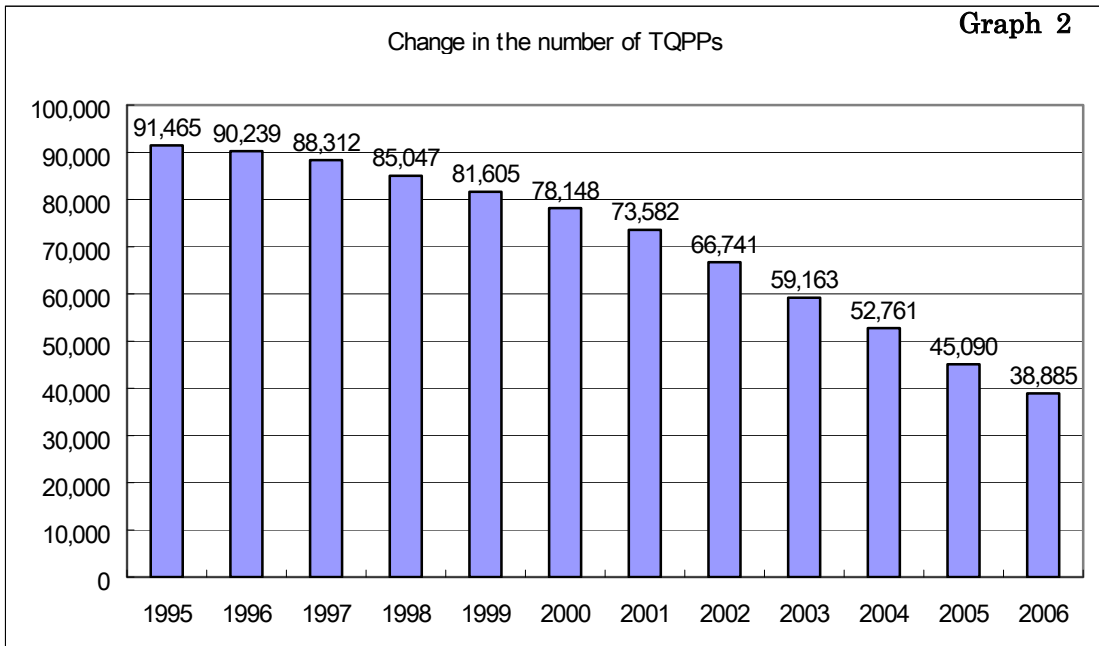
3.1 Some statistics

As explained in 1.4, TQPPs will be abolished by the end of March 2012, and the number of TQPPs is sharply declining as shown in graph 2.²

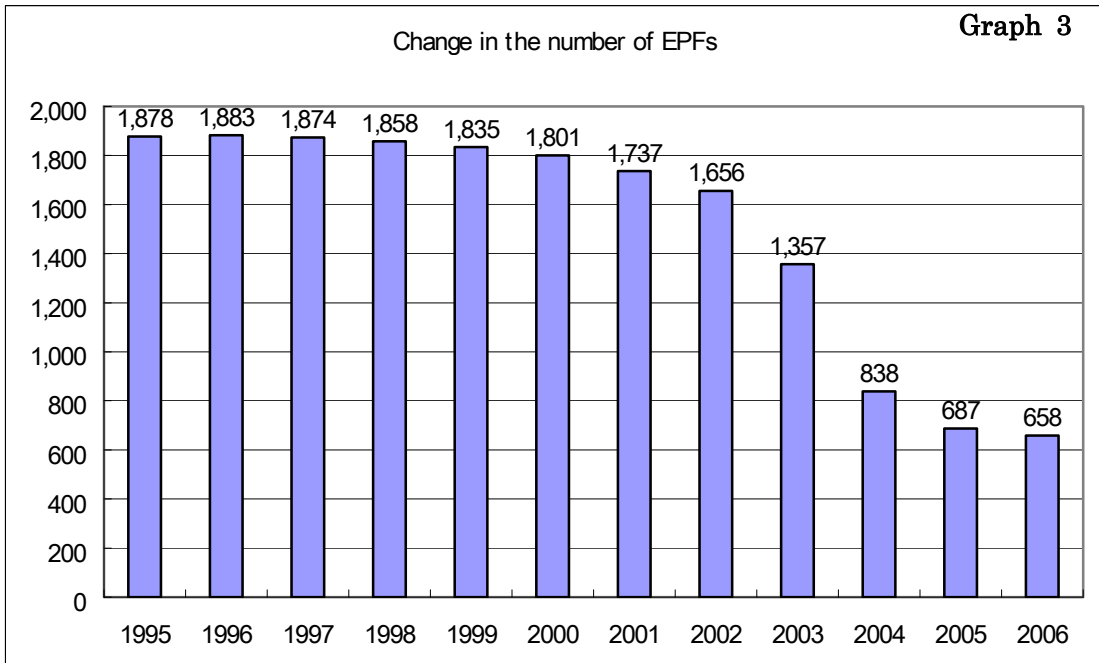
¹ Traditional defined benefit is usually one of following type:

1. Final pay related benefit
2. Career average pay related benefit
3. Fixed amount benefit (specified according to the employee's length of service and reason for resignation)
4. Point system (accumulation of points which are determined according to the job rank in the company)

² Sources of graphs 2-6: Pension Fund Association [2007]

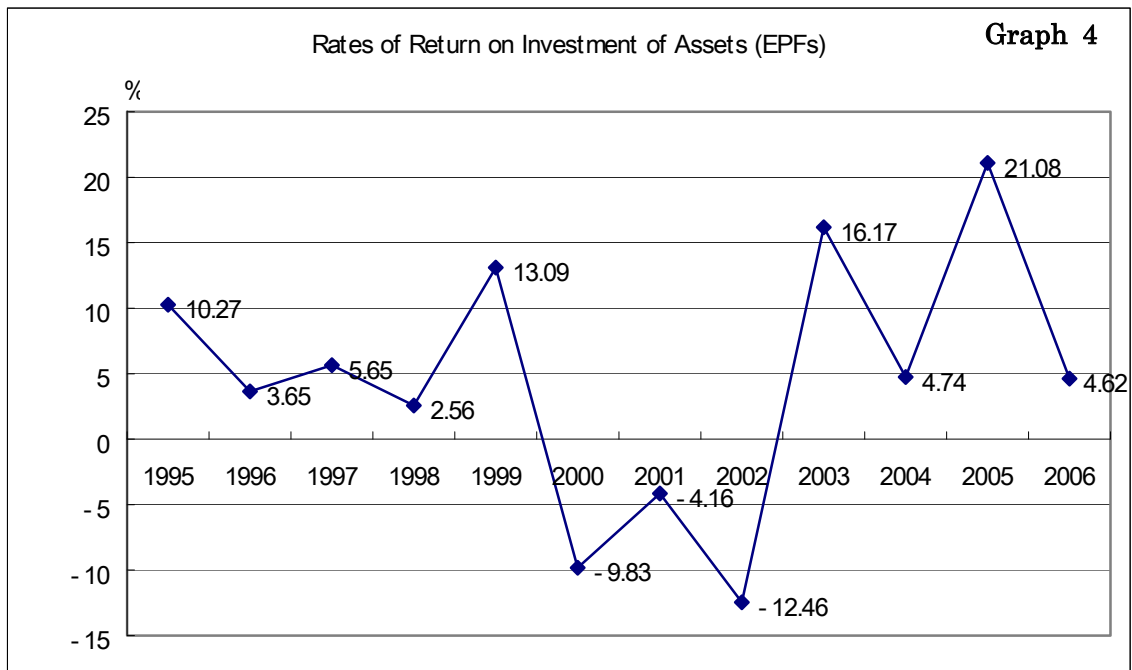


The number of EPFs is also in sharp decline beginning from 2002 as shown in graph 3. The main reason of the decline is the fact that many employers changed their EPFs into DBCPPs by separation of the substitutional portion (so-called “Daiko-henjo”).



Many employers experienced hardship in investment in the years of 2000-2002, which

is shown in graph 4. And they had to raise contribution rates³ in order to amortize the actuarial losses caused by the actual return on assets. To avoid the risk of bearing more contribution, employers chose the separation of the substitutional portion. And another reason of selecting separation was unfair treatment of substitutional portion in the employers' accounting for pensions in the Japanese GAAP. This unfairness will be explained later.⁴



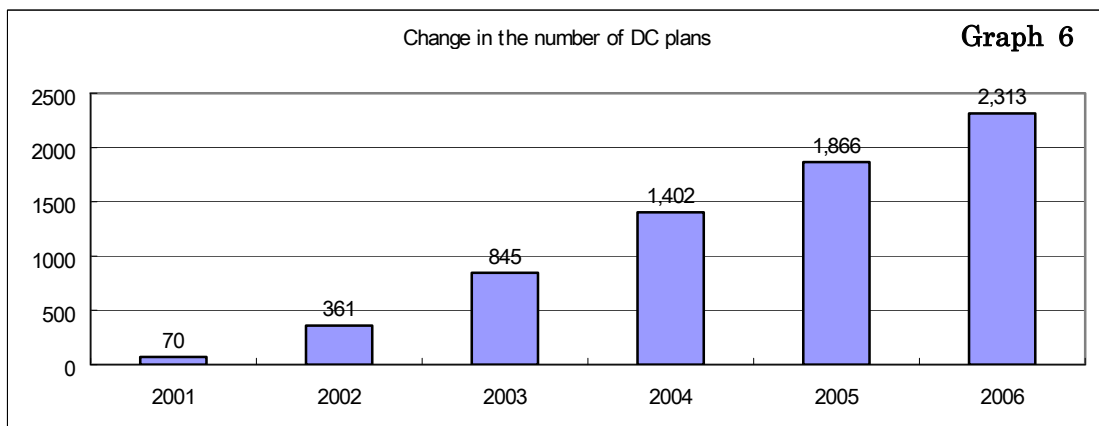
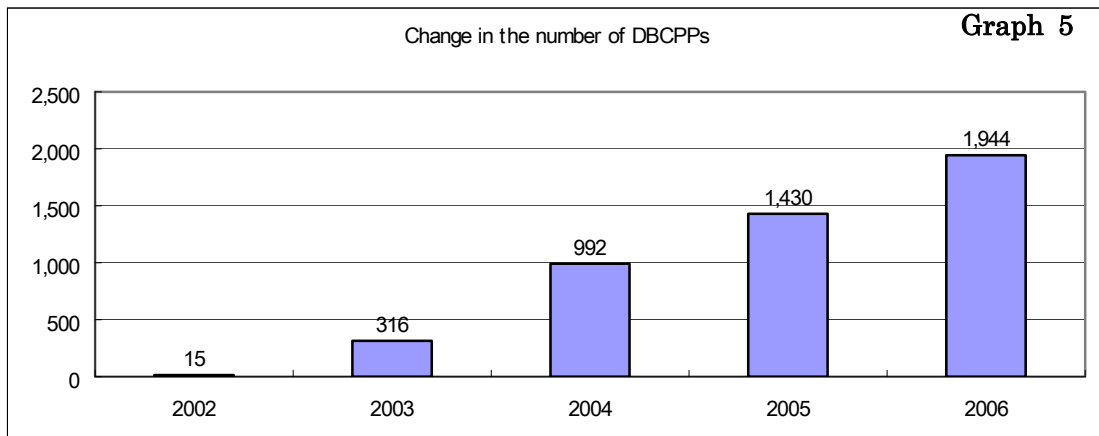
New type of corporate pension plans are growing in number steadily, as shown in the graphs 5 and 6. On December 1, 2007 there are 2,753 DBCPPs. And among them, 799 plans are established by the separation of substitutional portion of EPFs.⁵

The number of DC plans exceeds that of DBCPPs. But the assets share of DC plans is not so big compared to DB type plans. (See Table 3)

³ Some employers charged a portion of supplemental contribution to their employees.

⁴ See 4.1

⁵ Source: Pension Fund Association home page



Assets held by the Plans (in trillion yen)⁶ **Table 3**

Type of plans	Amount	Date of survey
TQPPs	17.3	March, 2006
EPFs	24.7	March, 2006
DBCPPs	22.1	August 2005 – July 2006
DC plans	2.2	March 2006

3.2 Efforts to continue DB type plans

I think it is true that increased market competition, stemming from deregulation and globalization, has weakened the competitiveness of corporate plan sponsors with large pension liabilities. And it is quite natural that many employers want to reduce their pension liabilities.

The most direct and effective way to make pension liabilities small is to abolish DB

⁶ Source: Pension Fund Association [2007]
Ministry of Health, Labor and Welfare home page

type plans or to convert them into DC plans.

But many Japanese employers did not select such extreme way, but made efforts not to discontinue DB type plans. And in order to reduce their large pension liabilities, they lowered the level of benefits of DB type plans. Examples of reduction are as follows:

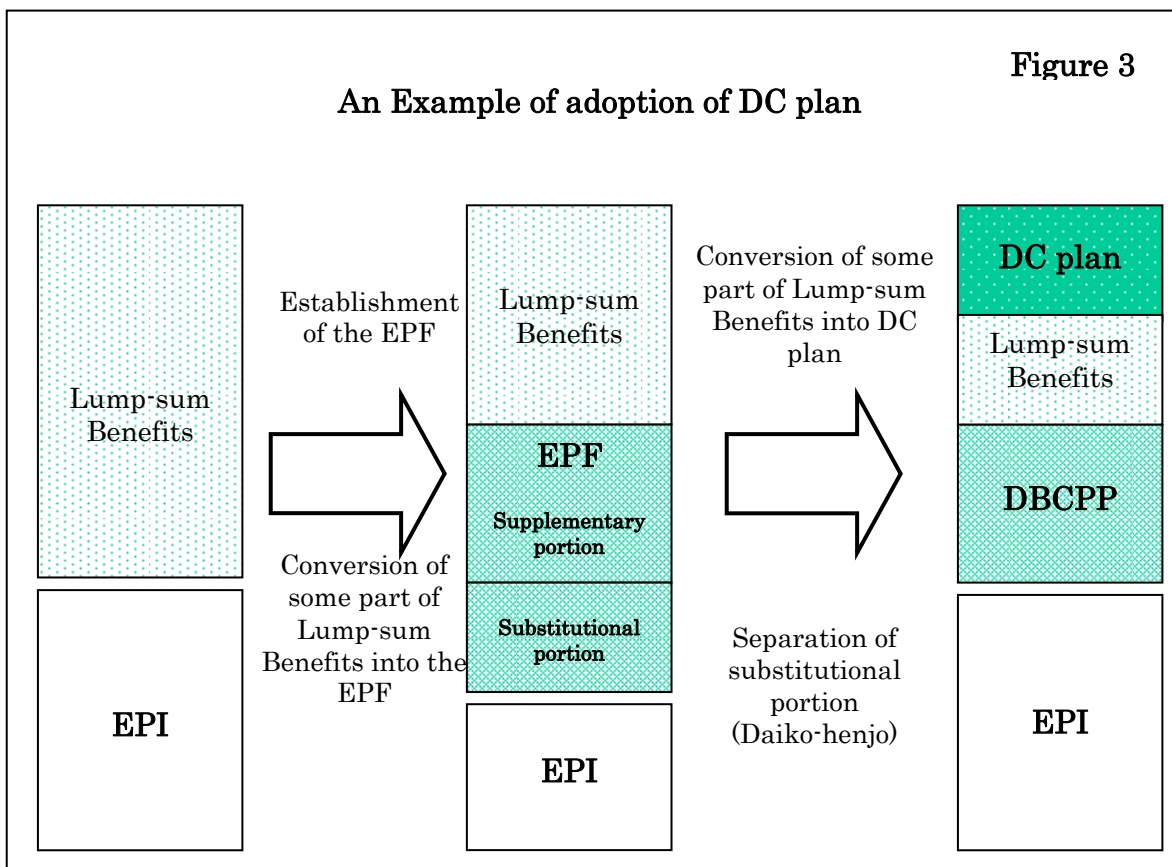
- One of common examples for decrease of pension benefits is reduction of the conversion rate (that converts a lump-sum benefit to a pension benefit), which reduces the interest included in the pension benefit. Employees accepted such reduction more easily than the reduction in the lump-sum benefit, because the interest is usually considered as just an addition to the lump-sum benefit. Adopting a Quasi Cash Balance Plan is normally an example of reduction of the conversion rate, because usually the rate is calculated as mean of 3 or 5 years of government bond rate, which is historically very low in current Japanese market.
- Next example is reduction of benefit period. Additional portion of EPFs must continue to pay pensions as long as the recipients live, as explained in 2.3. But this requirement is not applied to DBCPPs. Some employers made benefit period to be a certain years (for example, 10 years), at the transformation of their EPFs into DBCPPs by separation of substitutional portion. At this plan change, optional lump-sum benefits were not altered usually. And employees also accepted such changes more easily than the reduction in the lump-sum benefit.
- A more drastic example of the reduction of employee benefits was set under the change of the benefit formula. For example, by changing benefits that are related to final pay into benefits that are related to career average pay, some employers lowered the benefit level substantially. In such cases, according to the change of lump-sum payments, pension benefits were changed in the same way.⁷
- If the employer satisfies certain conditions, it can reduce the beneficiaries' pensions even after the commencement of annuity. This is a quite different practice from other countries including US and UK. But the required conditions

⁷ An extreme example to reduce the pension liabilities is abolishment of severance and retirement benefits for some employees. Newly hired employees of one of major companies have the rights to select to be covered or not by severance or retirement benefits. If an employee chose not to be covered, he/she receives increased monthly salary for compensation, and the employer does not have to recognize the pension obligation for him/her. But such an extreme case is not common.

for reducing the beneficiaries' pensions including consent of individual beneficiaries are very strict.

3.3 Current status of DC plans

Many employers chose DC plans for preparation of paying severance or retirement benefits to reduce their pension liabilities. But it is not common that a company converts all DB type benefits into DC plans. Many companies that use DC plans are adopting DB type plans at the same time (See Figure 3). I think it is because the systems that severance or retirement benefits that would fluctuate according to the market, are not so common in today's Japanese society. Under the current circumstances, most Japanese people (including employers) prefer more stable benefit systems. I think that's why the assets share of DC plans is not so big in Japan now.



4. Accounting standards for post-employment benefits

4.1 Some issues of Japanese GAAP

Current accounting standard for employers for post-employment benefits became effective in April 2000. It is very similar to FAS 87 and IAS 19.

There are very big issues in the treatment for the substitutional portions of EPFs.

By the Pension Reform in 2004, it was made clear by Employees Pension Insurance Act that an employer of EPF does not have any obligation for substitutional portion that exceeds Minimum Actuarial Liability (MAL).

But the Accounting Standards Board of Japan (ASBJ) did not change the standard that requires obligation for substitutional portion is calculated by Projected Unit Credit method (Same as PBO for FAS 87), whose amount is usually greater than MAL. Furthermore ASBJ decided that when the money to subsidize⁸ an EPF from EPI is delivered in order to stabilize the financial soundness of the substitutional portion, the amount of the money delivered to the EPF has to be deducted from the post-employment benefit costs in every occasion of delivery. These standards are completely wrong and mislead the users of financial reports.⁹

I would like to point out one more issue in current standard.

In addition to receiving “exemption contribution”, an EPF receives subsidies¹⁰ from EPI when it pays substitutional pension. In calculation of PBO for substitutional portion, these subsidies are exempted from the benefit, because the employer does not have any obligation for this part. This type of subsidies and another one (which will be delivered for the sake of financial soundness) are completely charged to EPI. And the former is exempted from calculation of PBO, and latter is included, although both have same meaning to employers. I think that if money of same meaning to an employer should be treated in an identical way. But these two types of subsidies are treated differently. I do not think that this standard is correct.

The Japanese Society of Certified Actuaries has been making comments that “The

⁸ This money is delivered when MAL becomes smaller than 50% of the actuarial present value of benefits of substitutional portion.

⁹ For more detailed explanation of this issue, refer to Shimizu [2007]

¹⁰ The amount of subsidy is calculated by the amount of substitutional pension, and beneficiary's date of birth etc. Maximum of subsidy is 17.5% of substitutional pension. This subsidy has existed from the start of EPFs.

substitutional portions should not be included in the calculation of PBO. And at the same time Assets equal to MAL should be subtracted from pension assets.¹¹ This is a very good way to cope with the issues mentioned above. But the ASBJ did not respond to these comments.

4.2 Upcoming new standard by IASB

IASB now has the project that is to issue an interim standard (phase 1) that would significantly change post-employment accounting. The Board is working towards a Discussion Paper, which is supposed to be published by the end of the first quarter of 2008.¹²

Among the Board’s current (December 2007) tentative decisions, the item “Presentation approaches for defined benefit promises” attracts my greatest concern. They are going to present 3 approaches for information about post-employment benefit costs could be presented as listed below.

Presentation approaches for DB costs

Table 4

Approach	Costs presented in profit or loss	Costs presented in comprehensive income
1	<ul style="list-style-type: none"> ● All 	<ul style="list-style-type: none"> ● None
2	<ul style="list-style-type: none"> ● Service costs ● Actuarial gains and losses on the defined benefit obligation except those arising from changes in the discount rate 	<ul style="list-style-type: none"> ● Interest cost ● Actuarial gains and losses arising from changes in the discount rate ● All changes in plan assets
3	<ul style="list-style-type: none"> ● Service cost ● Interest cost ● Actuarial gains and losses on the defined benefit obligation except those arising from changes in the discount rate ● Imputed interest income on plan assets determined using the discount rate determined by reference to market yields at the balance sheet date on high quality corporate bonds 	<ul style="list-style-type: none"> ● Actuarial gains and losses arising from changes in the discount rate ● Changes in the fair value of plan assets other than those included in profit or loss

Although the Board agreed that it should not express a preliminary view on the presentation of the components of pension cost in comprehensive income, I suspect that

¹¹ JSCPA [2006]

¹² IASB [December 2007] Project Update

strong recommendation for Approach 1 may be brought from outside of stakeholders. And even if the approach 1 is not adopted in phase 1, I think I must admit the future risk that actuarial gains and losses will be recognized only in profit or loss in the period in which they occur.

4.3 International convergence

The Accounting Standards Board of Japan (ASBJ) is now working with IASB, toward international convergence of accounting standards. This convergence has the merit of eliminating the burdens of both preparers and users of financial statements.

But when I consider the side effect of convergence, I must admit the future risks mentioned above may be brought into Japan.

If the immediate recognition of *all changes* (that include all actuarial gains and losses) in profit or loss is required in the future, employers with DB type post-employment benefits will be exposed to enormous risks of fluctuations in their profit or loss. Under such circumstances, many Japanese employers may give up their DB type plans in order to avoid such risks.

5. Concluding remarks

In Japan, traditional DB plans have worked very well to support post-retirement life. When DC plans and hybrid were introduced in the beginning of this century, many people said that almost all of DB plans would be changed to new plans. But many companies have made enormous efforts not to change DB type benefits. And it seems they would like to maintain the same structure in the future.

When the separation of substitutional portion of an EPF was introduced, the Japanese accounting standard for post-employment benefits was a one of major causes that tempted many employers to change their EPFs into DBCPPs. Thus the accounting standards have tremendous influence on post-employment benefits.

If the immediate recognition in profit or loss for actuarial gains and losses is required by amended accounting standard in the future, that change may cause many employers to give up their efforts to maintain their DB plans. And in that case, it may lead to very big issues for both employers and employees. This change toward immediate recognition of actuarial gains and losses has to be watched carefully.

I mentioned only the worst scenario of the future. But I believe with hope the worst

would not come soon.

I think one of good ways to avoid big risks for fluctuation in profit or loss is to develop a new measurement of benefit obligation, which can result in smaller amount of actuarial gains and losses.¹³

I think that the discussions on how to measure the benefit obligations properly should be more intensely dealt among the related people including actuaries and auditors. And I hope that great attention will be paid to actuaries in that discussion.

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¹³ For example, I’d like to propose that the obligation for an employees lump-sum benefits should be defined as the amount that would be paid to him/her if he/she quits on the measurement date (in Japan such amount is called “Yo-Shikyuugaku”). That way of measuring the obligation does not use any actuarial assumptions. That means there will be no actuarial gains and losses from Benefit Obligation. But this way is not omnipotent, because it can’t handle pensions for life in the same way. More detailed discussion will be needed.