Title: Legal Funding Rules on DB Plans in Japan and in the US

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Abstract: In this paper, I look into the legal minimum funding standards of defined benefit pension plans ("DB plans") in Japanese "Defined Benefit Corporate Pension Law" and in the US, brand-new "Pension Protection Act of 2006". I also compare these minimum funding standards for considering the desirable minimum funding standard in Japanese DB plans.

In Japan, the "Defined Benefit Corporate Pension Law" was enforced in April, 2002, and it is almost 5 years since then. In the rider of the "Defined Benefit Corporate Pension Law", reviewing and provision in 5 years are stated. Recently we are considering them thoroughly.

In the US, "Pension Protection Act of 2006" was enforced in August, 2006. It was enacted because of the financial crisis of the PBGC, and it includes the provisions for the purpose of strengthening the funding rules of DB plans.

The Defined Benefit Corporate Pension Law doesn't have the pension benefit guarantee system like the PBGC. In the supplementary resolution of the National Diet at the "Defined Benefit Corporate Pension Law" enactment, it is said that "From the aspect of the protection of the right of participants and beneficiaries, we will consider the installation of the pension benefit guarantee system which has a function as a safety net with avoiding the moral hazard". When the law is amended for the first time, we will consider whether we introduce the pension benefit guarantee system or not. I believe there is no probability that the pension benefit guarantee system will be introduced in Japan.

Under the circumstances of no pension benefit guarantee system, the legal funding rules are essential for the protection of the right of participants and beneficiaries and early full funding of pension assets. However, too strict regal funding rules lead to the impediment of the spread of the DB plans. Therefore we cannot generalize that we should strengthen the legal funding rules. Actually in Japan, many "Tax qualified pension plans"*, which plays an vital role in the corporate pension plans, are

terminating without transition to the other pension plan. I am afraid of the issues of decreasing the number of corporate pension plans in Japan.

*With the enforcement of the “Defined Benefit Corporate Pension Law”, the “Tax Qualified Pension Plan” has been decided to abolish by 2012. The legal funding rules of “Tax Qualified Pension Plan” are not strict compared to the ones of the “Defined Benefit Corporate Pension Plan”.

1. History of DB plans

In the US, between 2000 and 2002, investments reached its all time low and this period was called the “Perfect Storm”, which created serious funding shortfalls in the defined benefit pension plans (“DB plans”). At the same time, Japan was facing the same situation, which brought serious funding shortfalls to DB plans. If funding shortfalls continue to remain, participants may not be able to receive benefits that their DB plan had promised when ultimate situations like bankruptcy arises. The US and Japan have the legal minimum funding standard in order to minimize such a default risk.

In the US, the Pension Protection Act of 2006 (“PPA”) was enacted in order to make the finances of DB plans and the Pension Benefit Guaranty Corporation (“PBGC”) sound. President George W. Bush has said that the PPA is the most sweeping reform of America’s pension laws in over 30 years. The PPA created strict funding rules that aimed to ensure that employees actually receive their benefits. On the other hand these strict rules may freeze DB plans or abolish DB plans or shift to a defined contribution pension plans (“DC plans”), because, whether employers have a DB plan or not is an option.

While in Japan, some DB plans have serious funding shortfalls which were influenced by the bad investments performance from 2000 to 2002. However that hasn’t become a political problem like the US because there is no pension benefit guarantee system like the PBGC. Therefore in Japan, it isn’t such a big issue like the US to have strict funding rules. I believe we don’t need to make strict funding rules in Japan like the PPA, however I think there are some points we should learn from the PPA. In this paper, I look into the legal funding rules of DB plans in the Japanese “Defined Benefit Corporate Pension Law” and the PPA in the US. I also compare these funding rules to consider the desirable legal funding rules in Japanese DB plans.

First of all, I will summarize the history of legal funding rules in the US and in Japan.

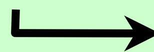
US

1974 : "ERISA" was enforced. Minimum Funding Standard

1987 : "Pension Protection Act of 1987" was enacted.

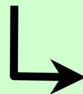
1994 : "Retirement Protection Act of 1994" was enacted.

2000 ~ 2002 : Perfect Storm

 PBGC's crisis arises.

2004 : "Pension Funding Equity Act of 2004" was enacted.

2006 : "Pension Protection Act of 2006" was enacted.

 The most sweeping reform of America's pension laws in over 30 years

In the US, it was 1974 when legal funding rules were introduced. The Employee Retirement Income Security Act of 1974 ("ERISA") created comprehensive funding rules in order to ensure that employees actually receive the promised benefits by their DB plan. After enforcement of the ERISA, legal funding rules became strict because of the "Pension Protection Act of 1987", and the "Retirement Protection Act of 1994". These two acts are enacted because of the financial crisis of the PBGC, which was made to takeover the funding shortfalls of DB plans. These two acts and the prosperity of plan assets made the finances of the PBGC sound, and then the PBGC got into the black in 1996. However since 2000, the "Perfect Storm" made a lot of company's bankruptcy. And then some employers terminated their DB plans with funding shortfalls, and those were taken over by the PBGC. And now the finances of the PBGC are very badly influenced by the "Perfect Storm" which they have never experienced before. That caused the enactment of the PPA. Bad finances of the PBGC existed when the legal funding rules were amended.

Generally speaking, legal funding rules exist to protect DB plans. However in the US, the funding rules of the ERISA exist to protect the PBGC more as compared to protecting DB plans.

Japan

1962 : "Tax Qualified Pension Plans" was introduced
1966 : "Employees' Pension Funds" was introduced

1997 : "Going-Concern" and "Non-Going-Concern" were introduced.
(only to the "Employee's Pension Funds")

2000 ~ 2002 : Bad investment performance

2001 : "DC Plan Law" was enforced
2002 : "DB Plan Law" was enforced → "Going concern" "Non going concern"

2007 : "DC & DB Plan Law" will be amended

2012 : "Tax Qualified Pension Plan" will be abolished

While in Japan, it was 1997 when two financial verifications, called "Going-Concern" and "Non-Going-Concern", were introduced to the "Employees' Pension Funds". After that the "Defined Benefit Corporate Pension Law" was enforced in 2002. This law also has two financial verifications. If the plan assets are less than a certain level, employers have to contribute more. On the other hand, other DB plans, called "Tax Qualified Pension Plans", don't have the financial verification of the "Non-Going-Concern", and the funding rules are not strict compared to the ones of the "Employees' Pension Funds". Therefore there were many cases where employees cannot receive the promised benefit. We had regarded the "Tax Qualified Pension Plans" as questionable. Then the "Tax Qualified Pension Plans" have been decided to be abolished by 2012, with the enforcement of the "Defined Benefit Corporate Pension Law". Recently employers, which have the "Tax Qualified Pension Plans", are thinking about shifting to the other pension plans, or abolishing their "Tax Qualified Pension Plans".

In Japan, there are three types of DB plans, "Employees' Pension Funds", "Defined Benefit Corporate Pension Plans" and "Tax Qualified Pension Plans". I will address the "Defined Benefit Corporate Pension Plans" that plays a key role in the DB plans after this.

2. Pension Benefit Guarantee System

The "Defined Benefit Corporate Pension Law" doesn't provide the pension benefit guarantee system like the PBGC. This law was enforced in August, 2002, and it has been almost 5 years since then. It is stated in the rider of the "Defined Benefit Corporate Pension Law" that reviewing and provision are required every 5 years. Therefore now we are trying to reconsider whether to introduce the pension benefit guarantee system or not.

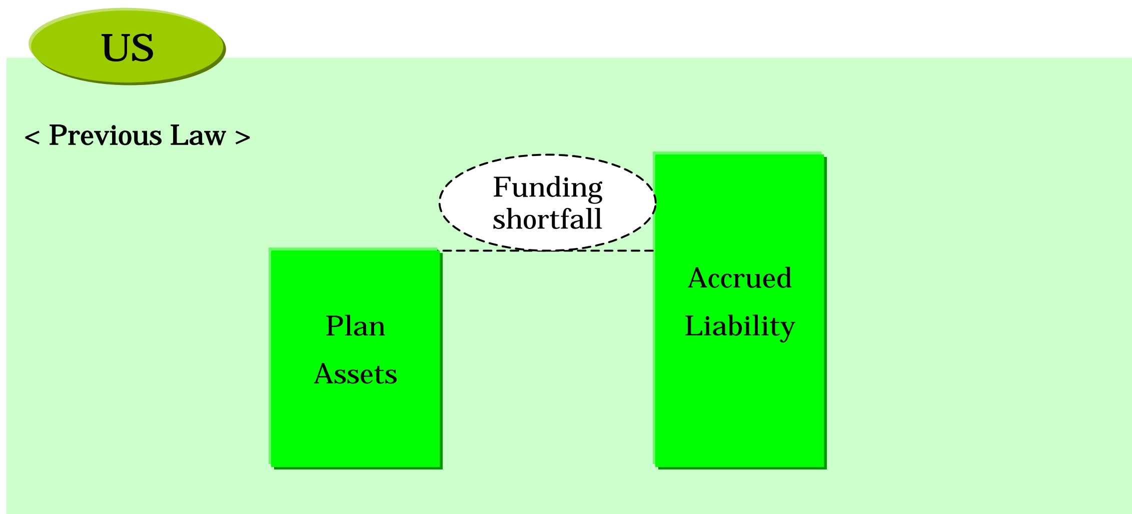
The pension benefit guarantee system looks like the most effective method to ensure that employees actually receive their benefits. However in the US, the financial crisis of the PBGC has led to the strengthening of DB plans' funding rules. And too strict funding rules may lead to the impediment of DB plans' development. If the number of DB plans decreases, there will be no point to keep the pension benefit guarantee system.

Why do we need the pension benefit guarantee system, anyway? We need it because in case of an occurrence of extreme circumstances, such as bankruptcy, employees cannot receive the benefits promised by their DB plan. If DB plans have adequate plan assets, employees can receive their promised benefits under any circumstances. Therefore, it is important to increase the plan assets ahead of time with the issue of "Non-Going-Concern" in mind. However there may be cases where DB plans are terminated with funding shortfalls. Then it is also important to have a preferential right of contributions. If there are two prerequisite like these, employees can certainly receive their benefits under the no pension benefit guarantee system.

In this paper, I will address the issue under the circumstances of no pension benefit guarantee system in Japan.

3. Legal Funding Rules in the US - Previous Law -

According to the previous law, there are two funding targets in the US.

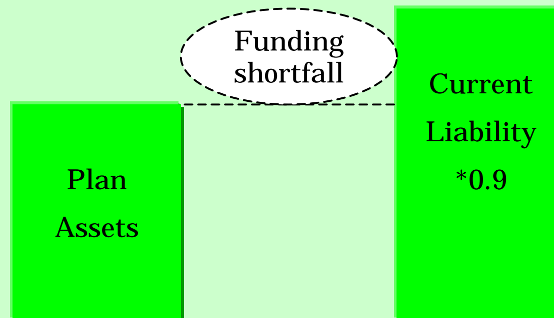


One of the funding targets is the “Accrued Liability”. Plan assets are compared to the “Accrued Liability”, which is based on projected future benefits, including future salary increases. And the amortization period of funding shortfalls is from 5 to 30 years for the “Single-Employer Defined Benefit Plans”. Amortization period depends on the measure of the loss. For instance, the initial past liabilities are paid off over 30 years, experience losses are paid off over 5 years and the losses of actuarial assumptions are paid off within 10 years.

DB plans are required to maintain a special account called “Funding Standard Account” to which specified charges and credits are made for each plan year, including a charge for normal cost and credits for contributions to the plan. A “Credit Balance” results, for instance, if contributions in excess of minimum required contributions are made. The amount of the “Credit Balance” is applied against charges to the “Funding Standard Account”, thus reducing required contributions. Since the “Perfect Storm”, the investment performance has been improved. However, there were some employers that reduced required contributions applying the “Credit Balance”. Therefore the funding level of DB plans has not been improved, since the “Perfect Storm”.

US

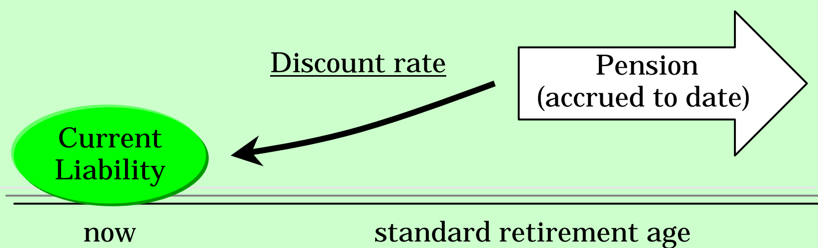
< Previous Law >



Another funding target is the "Current Liability". Plan assets are compared to 90 percent of the "Current Liability", which is a liability to plan participants accrued to date. That may be called a liability of the "Non-Going-Concern". If plan assets are less than 90 percent of the "Current Liability", employers have to contribute more. However, if plan assets are more than 90 percent of the "Current Liability" twice in the latest 3 years and plan assets of the year are 80 percent of the "Current Liability", employers don't have to contribute more exceptionally.

US

- The "Current Liability" is calculated as follows;



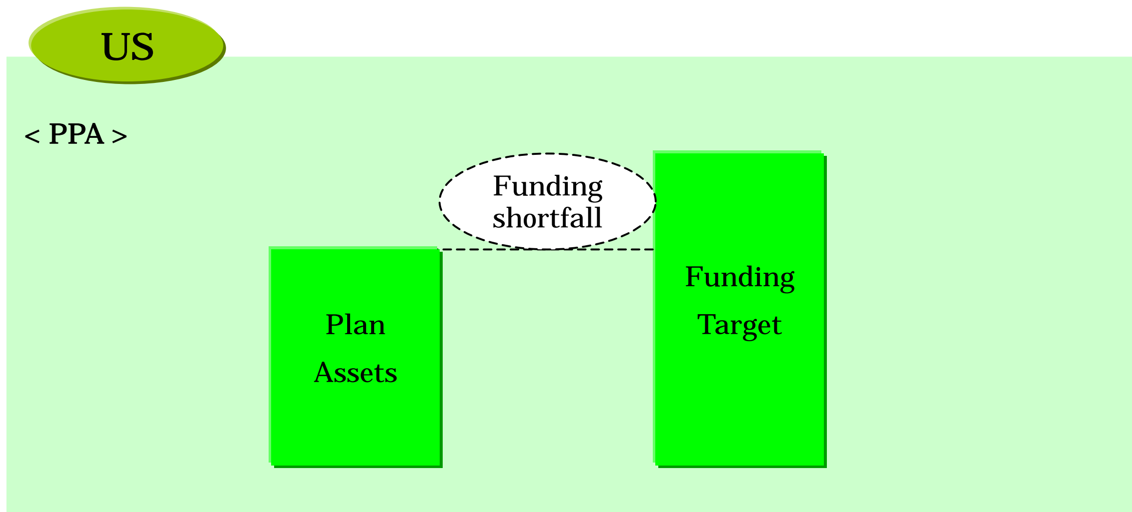
Both the "Current Liability" and plan assets are permitted to smooth. The assumed interest rates of the "Current Liability" can be within a permissible range of the weighted average of the interest rates on long-term investment-grade corporate bonds for the four-year period, and the permissible range for these years is from 90 percent to

100 percent. Therefore, employers can minimize the influence by fluctuations in stock prices, bond prices, etc. While the actuarial value of plan assets is not less than 80 percent of the “Fair Market Value” of plan assets and not more than 120 percent of the “Fair Market Value”, values may be used for a stated period not to exceed the 5 most recent plan years.

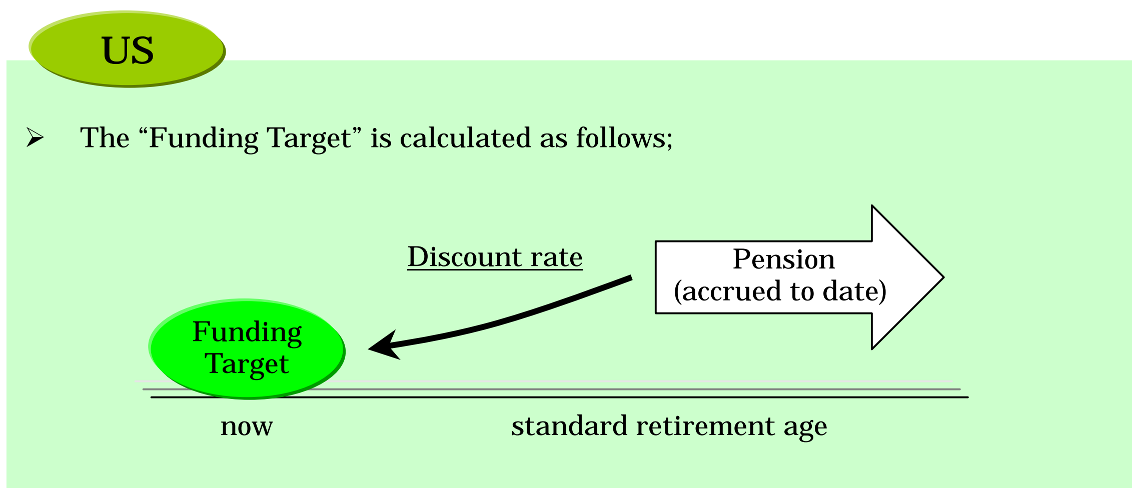
It seems to me that the “Smoothing” is aimed to minimize the influence by short term fluctuations. And employers have their discretion of the funding rules. The “Smoothing” is good for employers to contribute stably without twisting by short term fluctuations of market value. However on the contrary, employers delay to contribute more when investment performances become bad. In the case of the “Perfect Storm”, it is regarded that employers put off dealing with contributing of their funding shortfalls as questionable.

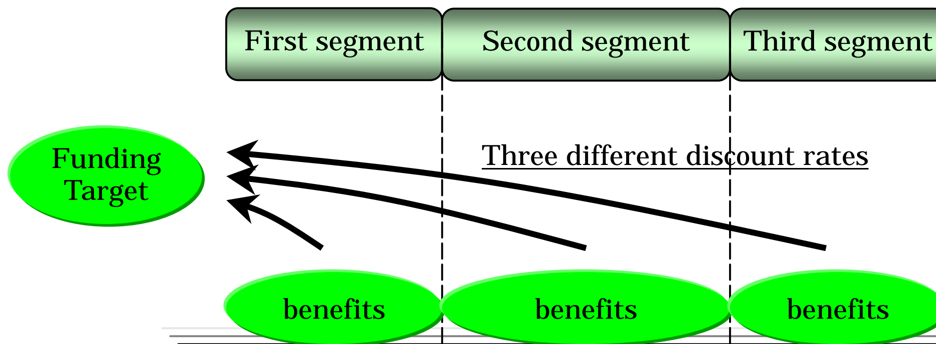
4. Legal Funding Rules in the US - PPA -

The PPA created the brand-new liability, called the "Funding Target", and employers have to contribute aiming 100 percent of the "Funding Target". Previously, employers needed to be conscious of the "Accrued Liability" and the "Current Liability", however after that, the ratio of the "Funding Target" to the plan assets is an absolute measure.



The "Funding Target" is similar to the "Current Liability", however, the "Funding Target" is calculated with the assumed interest rate that is determined using three interest rates ("segment rates"), each of which applies to benefit payments expected to be made from the plan during a certain period. Each segment rate is a single interest rate determined monthly by the Secretary of the Treasury on the basis of a corporate bond yield curve(24-month period). And employers cannot smooth the assumed interest rate like the "Current Liability".

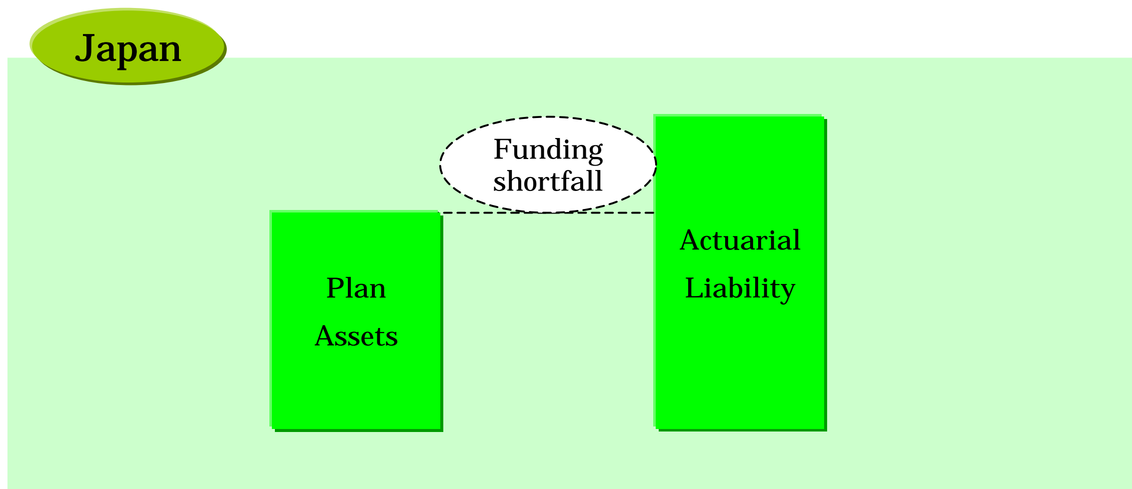




If plan assets are less than 100 percent of the “Funding Target”, employers have to contribute more in order to pay off their funding shortfalls over 7 years. According to the previous law, the maximum of the amortization period was 30 years. Therefore the PPA causes the amortization period to reduce very much. That leads to much contribution of DB plans, as a result, I think employers start thinking freezing DB plans or abolishing DB plans or shifting to a DC plan.

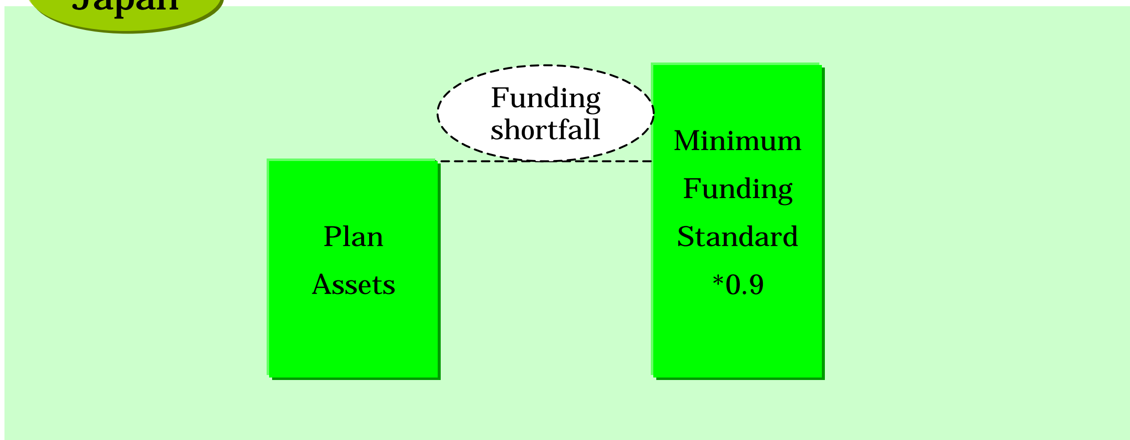
5. Legal Funding Rules in Japan - Defined Benefit Corporate Pension Law -

In Japan There are two financial verifications, called "Going-Concern" and "Non-Going-Concern".



The "Going-Concern" is the financial verification that DB plans will continue, in other words, won't be terminated forever. According to the "Going-Concern", plan assets are compared to the "Actuarial Liability", which is calculated as we subtract projected future normal costs from projected future benefits. The assumed interest rate of the "Actuarial Liability" is decided by employers as expected investment return rate. However, to tell the truth, employers tend to adjust their tolerable contribution by choosing a preferable assumed interest rate.

While the actuarial value of plan assets is generally the "Fair Market Value", however employers can choose the "Smoothing value" like the US. If the funding shortfalls, which subtract plan assets from the "Actuarial Liability", are more than the "Tolerant funding shortfall", employers have to contribute more in order to cover their funding shortfalls. The amortization period of funding shortfalls varies from 3 to 20 years. Once employers decide the amortization period, the employers cannot put off that period anymore. As a result, employers hesitate to contribute big charges because the time will come when they won't be able to contribute such big charges.

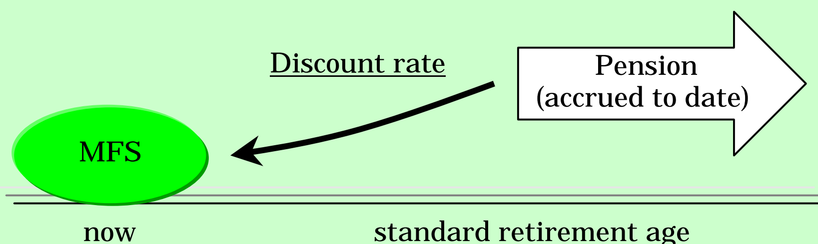


Another financial verification, called the "Non-Going-Concern", is the assumption that DB plans will be terminated soon. If DB plans have been terminated, participants are entitled to receive the "Minimum Funding Standard", which is the present value of employees' benefits accrued to date. According to the "Non-Going-Concern", plan assets are compared to the 90 percent of the "Minimum Funding Standard". However, if plan assets are more than 90 percent of the "Minimum Funding Standard" twice in the latest 3 years and plan assets of the year are 80 percent of the "Minimum Funding Standard", employers don't have to contribute more exceptionally. This is the same rule of the previous law in the US.

When employers terminate their DB plan, all of their plan assets are provided to their participants. On the other hand plan assets may be less than the "Minimum Funding Standard", and then participants cannot receive their promised benefits. Therefore employers must contribute all of their funding shortfalls, when plan assets are less than the "Minimum Funding Standard".

Japan

- The "Minimum Funding Standard" is calculated as follows;



The assumed interest rate of the "Minimum Funding Standard" is decided by the Minister of Health, Labor and Welfare as 30-year Treasury securities for the five-year period. This assumed interest rate must be within a permissible range that is from 80 percent to 120 percent of the one. If plan assets, which are the "Fair Market Value", are less than the "Minimum Funding Standard", employers have to contribute more in order to cover their funding shortfalls. The method of contributing is different between "Going-Concern" and "Non-Going-Concern". According to the "Non-Going-Concern", employers can select one of the two methods. One of them is to contribute according to the funding level of their DB plan. Another one is to simulate in 10 years, and check the funding level of 10 years later. If plan assets are less than the 90 percent of the "Minimum Funding Standard" in 10 years, employers have to contribute more to recover their finances of DB plan.

Employers can contribute all of the funding shortfalls at a time. According to the "Going-Concern", employers cannot contribute within 3 years, however according to the "Non-Going-Concern", they can. I believe that's because the "Non-Going-Concern" is more important than the "Going-Concern".

Ten years have passed since two financial verifications had been introduced. It seems to me that the "Non-Going-Concern" has not yet been fully recognized. Employers are conducting their financial management being aware of "Going-Concern", not "Non-Going-Concern". However in Japan, there is no pension benefit guarantee system, and there isn't a preferential right of contributions. If DB plans are terminated, employees may not be able to receive their benefits. Therefore I think employers should conduct their financial management being aware of "Non-Going-Concern" more.

6. Conclusion

In the US, the PPA created uniform funding rules, and employers conduct their funding management regarding "Non-Going-Concern" as necessary. It seems to me that it's a very important point of view, because, if DB plans have adequate plan assets to the "Non-Going-Concern", participants can receive their benefits under any circumstances. The bottom line is that employers should be conscious of the funding level of "Non-Going-Concern" every plan year. And if plan assets are less than a liability of the "Non-Going-Concern", the funding shortfalls should be covered as soon as possible. In Japan there is no pension benefit guarantee system, therefore I think this point of view is more important than the US.

While the situation must be improved as soon as possible when plan assets are less than the "Minimum Funding Standard". According to the "Defined Benefit Corporate Pension Law", employers can contribute all of the funding shortfalls, which are less than the "Minimum Funding Standard", at a time. Therefore, for instance, we should introduce the rules that the funding shortfalls are paid off within 20 years, and employers can change the amortization period within 20 years at any time. And the contribution of the funding shortfalls should have a preferential right, when plan assets are less than the "Minimum Funding Standard".

We should be cautious whether we introduce other amendments of the PPA regarding the "Smoothing" or not. If the latitude of the "Smoothing" becomes narrow, employers may terminate their DB plans. That is not favorable for employees. Therefore it seems to me that we need the "Smoothing" to a certain extent.

In Japan, "Defined Benefit Corporate Pension Law" is amended before long. This amendment may be affected by the PPA. However, the situation is different from the US and Japan. In particular, the US has the pension benefit guarantee system but Japan doesn't, that is a big difference. After due consideration of the difference, we should consider the first amendment. I believe that we never make a choice that DB plans is declining.