2016 Expected Reform of Japanese DC Code and Its Implications for the Future DC Prevalence in Japan as Contrasted to US 401k

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Abstract
A proposal for Japanese taxation law updates, announced by the current ruling parties at the end of 2014, includes some remarkable suggestions that are likely to change Japanese DC prevalence drastically in the future. That is, likely in 2016, the government will expand the coverage of Japanese Individual DC ("JIDC") to the whole nation as part of a key governmental arrangement for individual retirement savings planning for the mid- and long-term.

The majority of developed countries are facing various issues related to social security, including pension benefits, and a movement to convert traditional DB plans to hybrid- or pure-DC plans has been observed all over the world. Fortunately or unfortunately, Japan is on the front line in terms of population aging and collateral difficulties, and thus its actions should warrant close and continued attention.

This paper firstly describes the current Japanese pension system, from a high level, with a focus on DC schemes and key points in the government's proposal. In particular, the proposal indicates the government's intention to enhance JIDC as a basic DC platform instead of Japanese Corporate-Sponsored DC ("JCDC"), which has played a big role thus far. Therefore the proposal may mark a turning point in the Japanese DC history.

Next, this paper covers historical background and outstanding issues with respect to the Japanese pension system. It discusses the government's effort to resolve the issues, the intendment of the proposal, and a picture of a possible future DC structure for Japan.

Finally, concentrating on corporate-sponsored private pensions for the employed, the current situation and future vision for Japanese DC is compared to the US's 401k and Individual Retirement Account ("IRA") to identify commonalities and differences between the two. Also presented is a line of further research themes to be closely investigated going forward.

Key words
Japanese DC, code reform, US 401k and IRA

1. Introduction

Japan is a nation with a universal health-care and pension system covering the whole public which was established by the National Pension Act and National Health Insurance Act in the late 1950's. The past decades have brought significant economic and cultural shifts, and there have been various updates made to the Japanese pension system as part of efforts to assure post-retirement financial security for the public. One of the remarkable changes is enforcement of Defined Contribution Pension Act in 2001 that allows corporations to sponsor tax-qualified defined contribution pension plans. Subsequent legislation has been designed to encourage use of defined contribution pension schemes by corporations as a means of providing their employees with supplemental resources for post-retirement life on top of state pensions provided by the universal pension system. At the same time, individual defined contribution pension plan became allowable for individuals who are not covered by a corporate-sponsored scheme.

Having had a long history of defined benefit pension plans, the initial introduction of defined contribution pension plans in Japan was not very progressive particularly in terms of contribution limits and coverage. Recently, for corporate-sponsored scheme, "employee" matching contributions were allowed from 2012 and the total contribution limits (per month) were increased from 51,000 JPY to 55,000 JPY in 2014 (and subsequent increases are expected), but coverage has not been revised thus far.

However, at the end of 2014, the current ruling parties submitted a proposal to expand the coverage of individual defined contribution plans and increase the contribution limits. The proposal will be enacted at some point in 2016, once the parliament approves.

Section 2 summarizes the current Japanese pension system in order to provide context to the following discussions including an explanation of the proposal. Next, Section 3 discusses the proposal's suggestion. Section 4 explains outstanding issues with Japanese pension systems and how the proposal will potentially change the current environment. Section 5 presents a comparison of Japanese and American DC plans. Lastly, Section 6 concludes this paper and lists research themes to be tackled in the future.

2. An overview of the current state of Japanese pension plans

Chart 2.1 is an illustration of Japanese state and corporate pension plans. All Japanese citizens aged between 20 and 60 can be categorized into the following 3 groups:

- Class 1 insured: self-employed individuals / approx. 18.1 million people
- Class 2 insured: employed individuals / approx. 40.0 million people
- Class 3 insured: spouses of Class 2 insured without earnings / approx. 9.5 million people

* The numbers of individuals in each category are as of March 2013

Tier 1 and 2 pension plans cover the entire public as state pension schemes and Tier 3 pension plans are tax qualified arrangements sponsored by private organizations (i.e. currently no Tier 3 schemes for public servants) which supplement the state pension schemes. Since 2001, companies are allowed to establish a defined contribution pension plan (as opposed to a traditional defined benefit pension plan) and Class 1 insured (and Class 2 insured but public servants if their companies do not sponsor externally funded pension plans) are also allowed to contribute money to an individual defined contribution pension account which can be purchased from many financial institutions. Table 2.1 summarizes supplemental (Tier 3) pension arrangements that can be provided to Class 2 insured except for public servants.

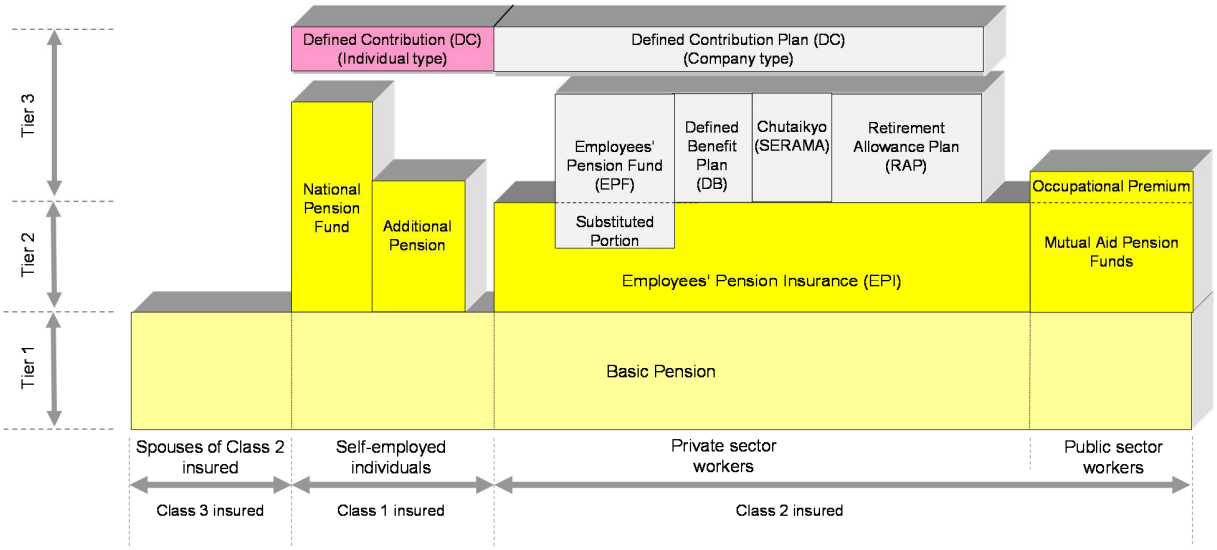

Chart 2.1: Japanese pension overview

As mentioned in the previous section, DC contributions are limited and the latest regulations are as follows:

- JCDC (Japanese Corporate-Sponsored DC) – employer contribution cap
    - If the employer provides a separate externally funded DB scheme (except for SERAMA): 27,500 JPY per month
    - Otherwise: 55,000 JPY per month
- JIDC (Japanese Individual DC) – individual contribution cap
    - Class 1 insured: 68,000 JPY per month
    - Class 2 insured with no externally funded DB scheme: 23,000 JPY per month

Table 2.1: Comparison of supplemental pension schemes sponsored by companies

	DB / DC	Financing	Note
RAP	DB	Book reserved	High flexibility
EPF		Externally funded	To be abolished / No new establishment approved
DB			Minimum number of participants (about 100) (as a business practice, not legal requirement)
DC	DC		Low contribution limit
SERAMA	(Employer) DC (Employee) DB		•Sponsored by semi-public entity, with 1.0% of guaranteed return •Maximum headcount and/or capital eligibility requirement

Also, JCDC may allow employees the option to match the employer contributions within the cap described above (i.e. the sum of employer and employee contributions are limited to 27,500 JPY or 55,000 JPY).

While Chart 2.2 shows that the number of employees covered by JCDC has increased to around 4.5 million over a decade, it accounts for just 10% of the 40 million Class 2 insured as at 2014. This slow dissemination is partially due to employers' perceptions that the contribution cap makes DC-oriented pension schemes insufficient to provide enough benefits to attract employees.

Furthermore, the number of individuals who have a JIDC account is even lower than that for JCDC. The statistics are shown below.

- Class 1 insured: 57 thousand people (0.3% of Class 1 insured)
- Class 2 insured: 126 thousand people (0.3% of Class 2 insured)

Currently, Japanese DC has become recognized as another type of corporate sponsored pension plans which have traditionally been defined benefit types, and while it has been penetrating the Japanese market gradually through companies' efforts, the pace is slow. In addition, JIDC is has had considerably less penetration than JCDC.

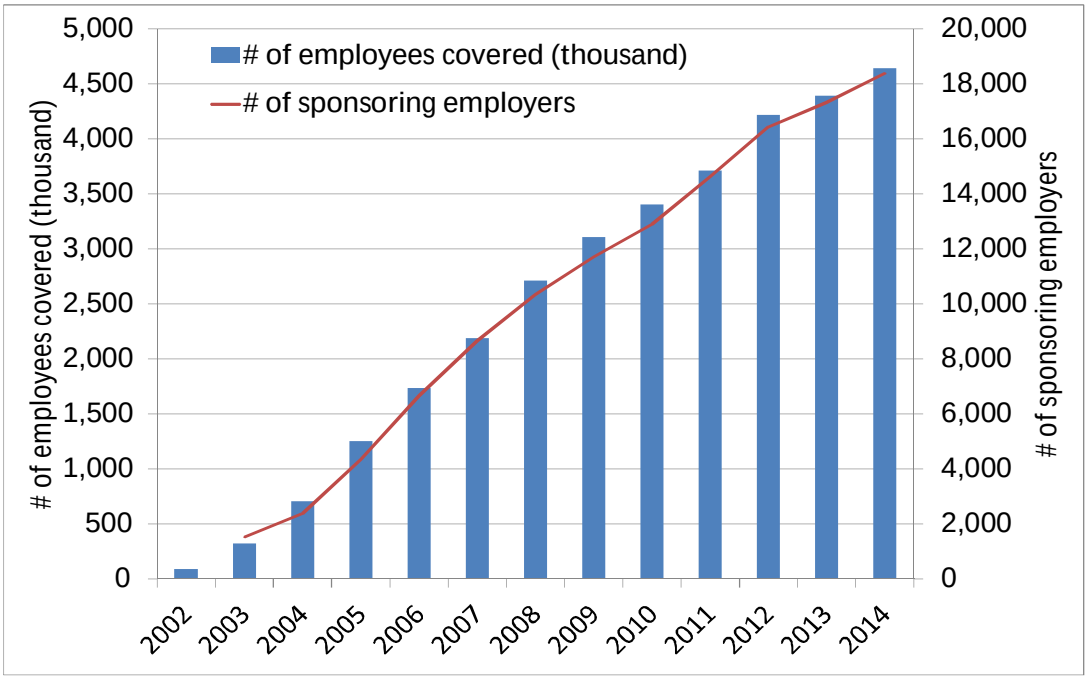

Chart 2.2: prevalence of JCDC (Japanese Corporate-Sponsored DC)
(Source: Ministry of Health, Labor and Welfare)

3. Changes suggested in the proposal by the ruling parties

The current ruling parties announced a proposal for Japanese taxation law updates that include changes in Japanese DC regulations. The key points are:

1. Contribution cap would be defined on an annual basis rather than a monthly basis
2. Eligibility for JIDC would be expanded to include
    - public servants (a part of Class 2 insured)
    - nonworking spouses (Class 3 insured)
    - employees at companies sponsoring any externally funded pension scheme (a part of Class 2 insured)
3. Companies with less than 100 employees (threshold is still under discussion) will be allowed to pay employer contributions to their employees' JIDC account instead of sponsoring a JCDC
4. DC account portability would be enhanced

Chart 3.1 illustrates the first 2 points of the above. Expanding the JIDC's coverage to the remaining portion of Class 2 insured that have not been allowed to use JIDC will have definite impacts considering there is a large population in this group.

The third point is to encourage small and medium-sized enterprises who cannot afford to sponsor their own corporate-sponsored defined contribution arrangements to provide their employees with defined

contribution pension benefits through JIDC, not JCDC which is more costly from employer perspective. Since the majority of Class 2 insured are employed by these types of companies (please refer to Appendix), this change may be a detonator for growth of the population covered by defined contribution pension scheme.

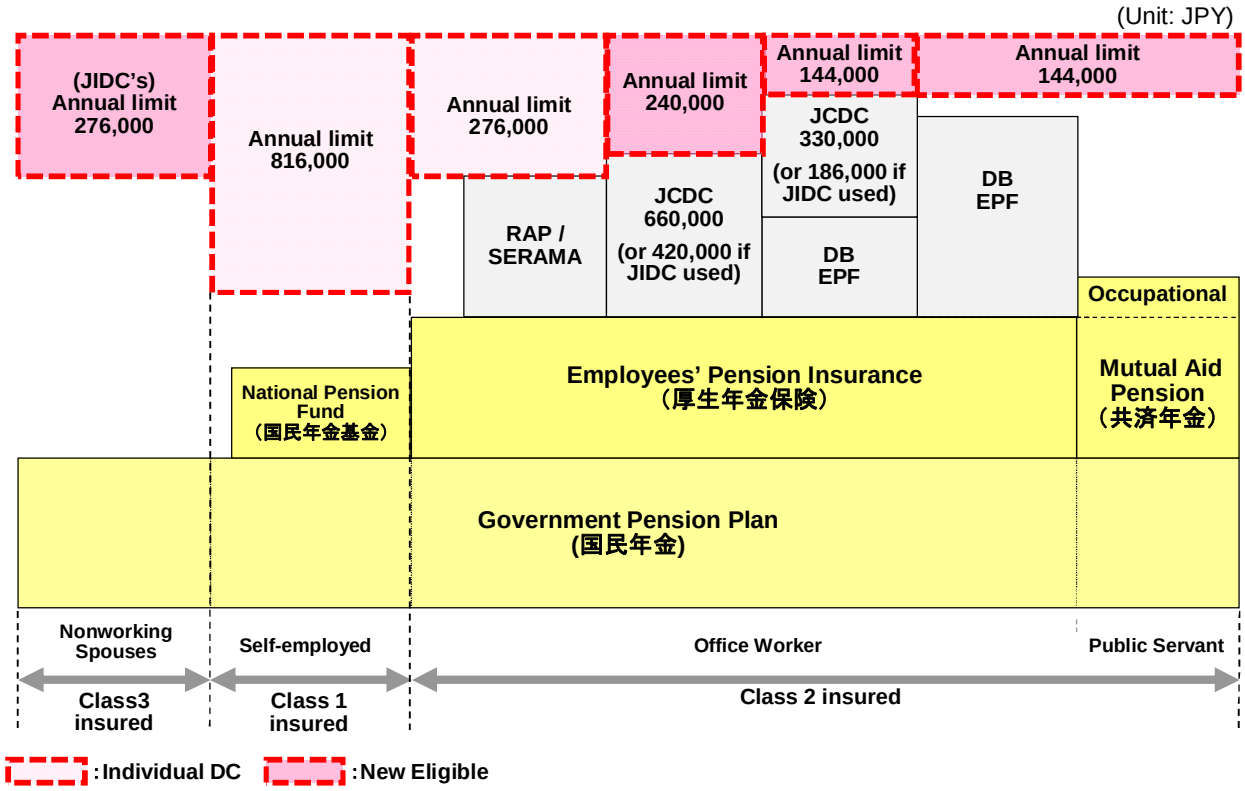

Chart 3.1: The expected new coverage of JIDC and contribution cap for each group

Lastly, Table 3.1 summarizes the last point of the proposal. Asset transfer among DC, DB and SERAMA – subject to individual plan conditions - would be allowed once the proposal becomes effective.

In summary, the proposal is aimed at changing the current DC regulations in terms of coverage and it seems that the proposal intends to promote JIDC as a platform for individual retirement savings as well as a replacement for JCDC ultimately by making existing JIDC features more flexible for different needs.

Table 3.1: Expected changes in asset portability

		Transfer to			
		DB	**JCDC**	**JIDC**	**SERAMA**
Transfer from	**DB**	Yes	Yes	Yes	No⇒Yes※
	JCDC	No⇒Yes	Yes	Yes	No⇒Yes※
	JIDC	No⇒Yes	Yes		No⇒Yes※
	SERAMA	Yes but regulated	No⇒Yes※	No⇒Yes※	Yes

※ Asset transfer on an aggregate company basis is allowed while individual asset transfer is not

4. Current issues with Japanese pension system and how the proposal may improve the situation

As widely known, Japanese have long life expectancy which has been improving as shown in Chart 4.1 below.

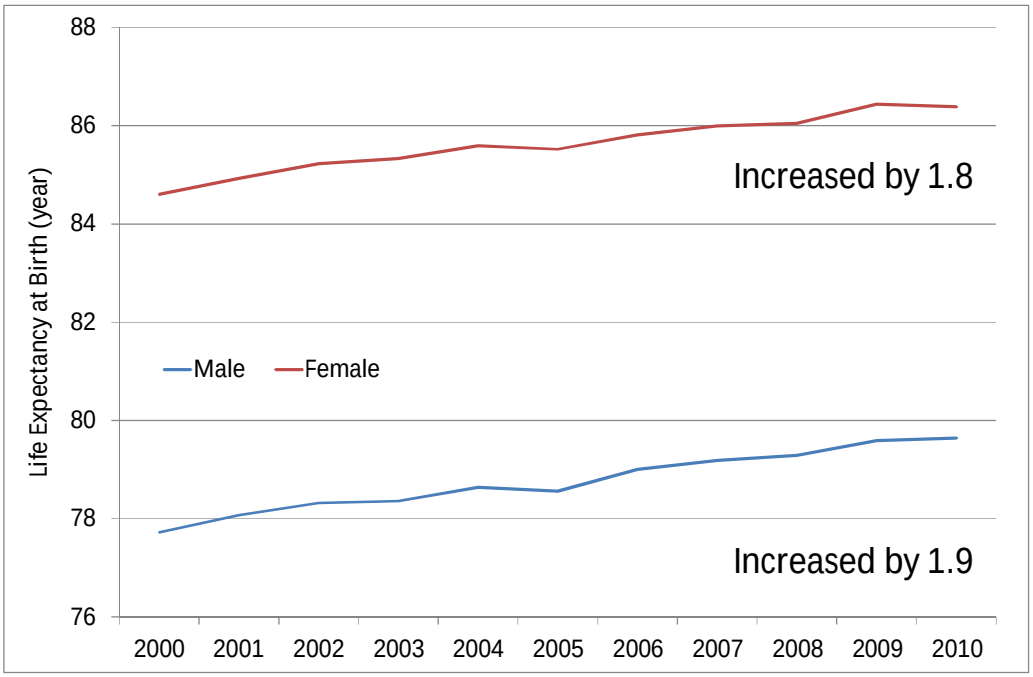

Chart 4.1: Transition of life expectancy of Japanese
(Source: Ministry of Health, Labor and Welfare)

Since Japanese state pensions provide life annuities, expenditure of the state pension systems are increasing as seen in Chart 4.2, which deteriorates their solvency.

As countermeasures, the government initially increased the pension commencement age – e.g. currently an annuity through Employees' Pension Insurance is receivable at age 65 while it was age 55 in the past. Also, the government is trying to encourage the public to work longer by increasing the mandatory retirement age (employment termination age) from 60 to 65 gradually so that the public can find job opportunities until the postponed pension commencement age.

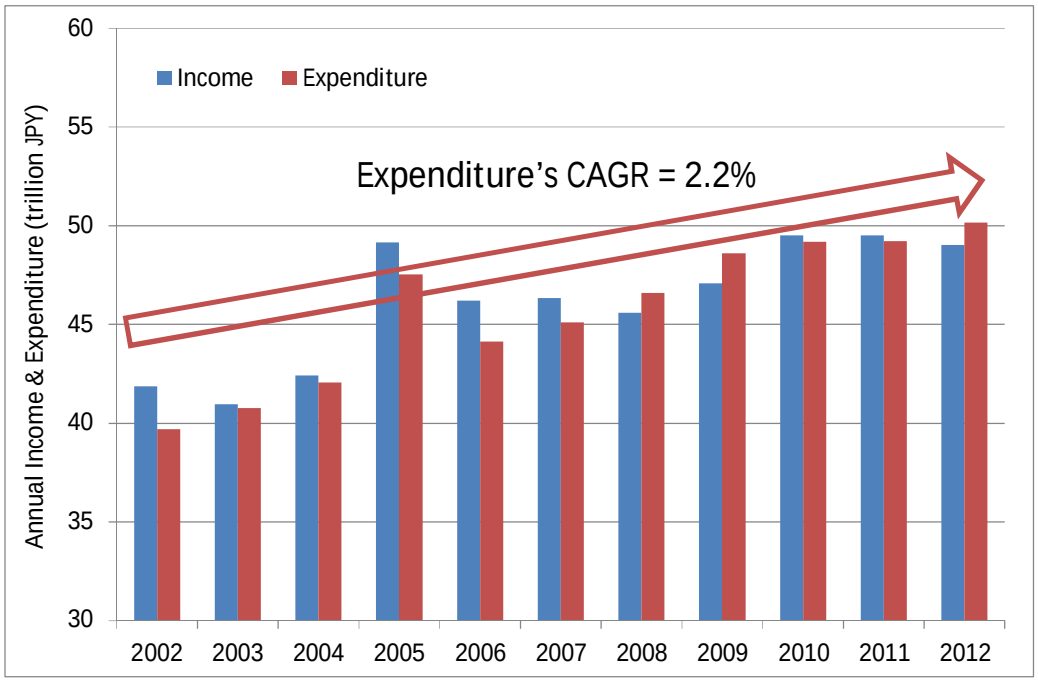

Chart 4.2: Transition of annual income and expenditure of state pension systems (Source: Ministry of Health, Labor and Welfare)

Given the above issues and consequent governmental actions, the desired private pension arrangement will be shifted from "Horizontal Combination" to "Vertical Combination" of labor income and pension, to use the words of KUBO (2010). The definitions of these combinations in KUBO (2010) are as demonstrated in Chart 4.3, Chart 4.4, and Table 4.1. In essence, "Vertical Combination" segregates post-employment income resources into pieces with clear distinct periods and thus each part including private pensions can be designed to ensure respective consequential costs are manageable and affordable.

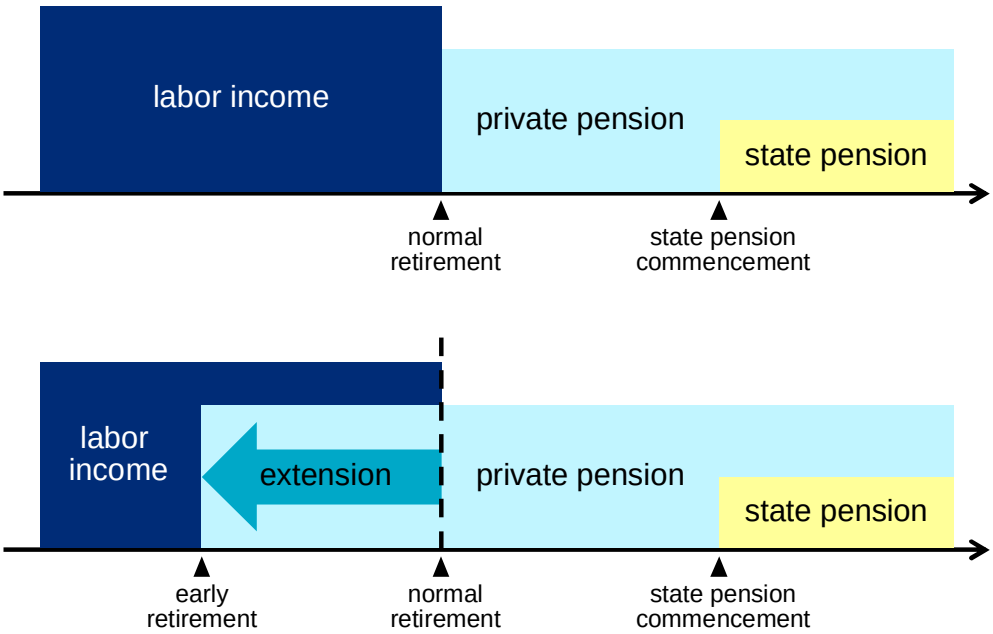

Chart 4.3: Illustration of "Horizontal Combination"
(prepared by the author with reference to KUBO (2010))

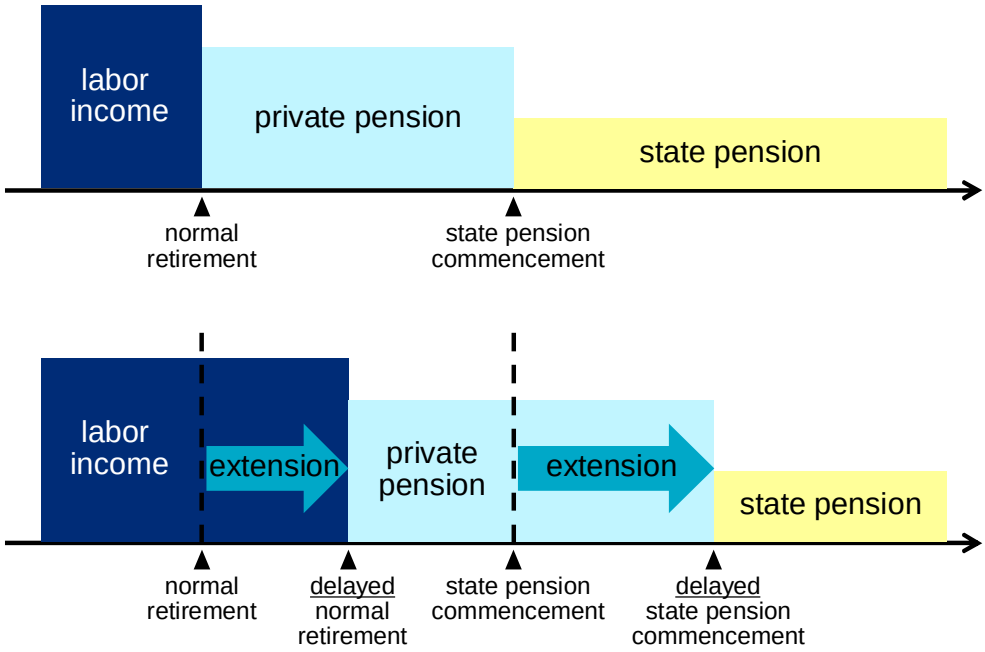

Chart 4.4: Illustration of "Vertical Combination"
(prepared by the author with reference to KUBO (2010))

Table 4.1: A comparison of Horizontal/Vertical Combination of pension systems (prepared by the author with reference to KUBO (2010))

Private Pension's	Horizontal Combination	Vertical Combination
Role	Supplemental income resource on top of labor income and/or state pension	Income resource during a transition period between retirement age and state pension commencement age
Design	Should be a life annuity in addition to state pensions	Should be a certain annuity during the period
Financial Burden to Sponsor	Significant	Moderate

Over time there have been changes in employees' mindset. Since the late 1990's when the Japanese economy was in a slump, career development through job switches has been popular rather than traditional life time employment. Therefore, the need for portability of accumulated retirement savings is increasing.

Putting it all together, Japanese private pension arrangements should:

- Be a part of "Vertical Combination" – i.e. provide an income during the period from retirement age to state pension commencement age
- Be portable during the whole working life regardless of job changes

Defined contribution pension schemes should be promoted as they can be regarded as a good fit to the above criteria. The proposal will likely change the current regulations that are not flexible in terms of coverage and portability – e.g. currently, if one leaves a company sponsoring a JCDC and joins a firm with an externally funded pension plan, which we often see, one may not keep receiving employer contributions nor pay individual contributions due to their new private pension plan – and improve DC prevalence in Japan.

Ultimately, it is possible that the proposal will make JIDC a ubiquitous device for securing post-retirement income resources, similar to a bank or brokerage account. The below illustrates an example of this idea assuming the following private pension plans sponsored by imaginary companies:

- Company A: provide 5% of pay in the form of DC as a private pension benefit
- Company B: provide 7% of pay in the form of an externally funded DB
- Company C: no pension plans

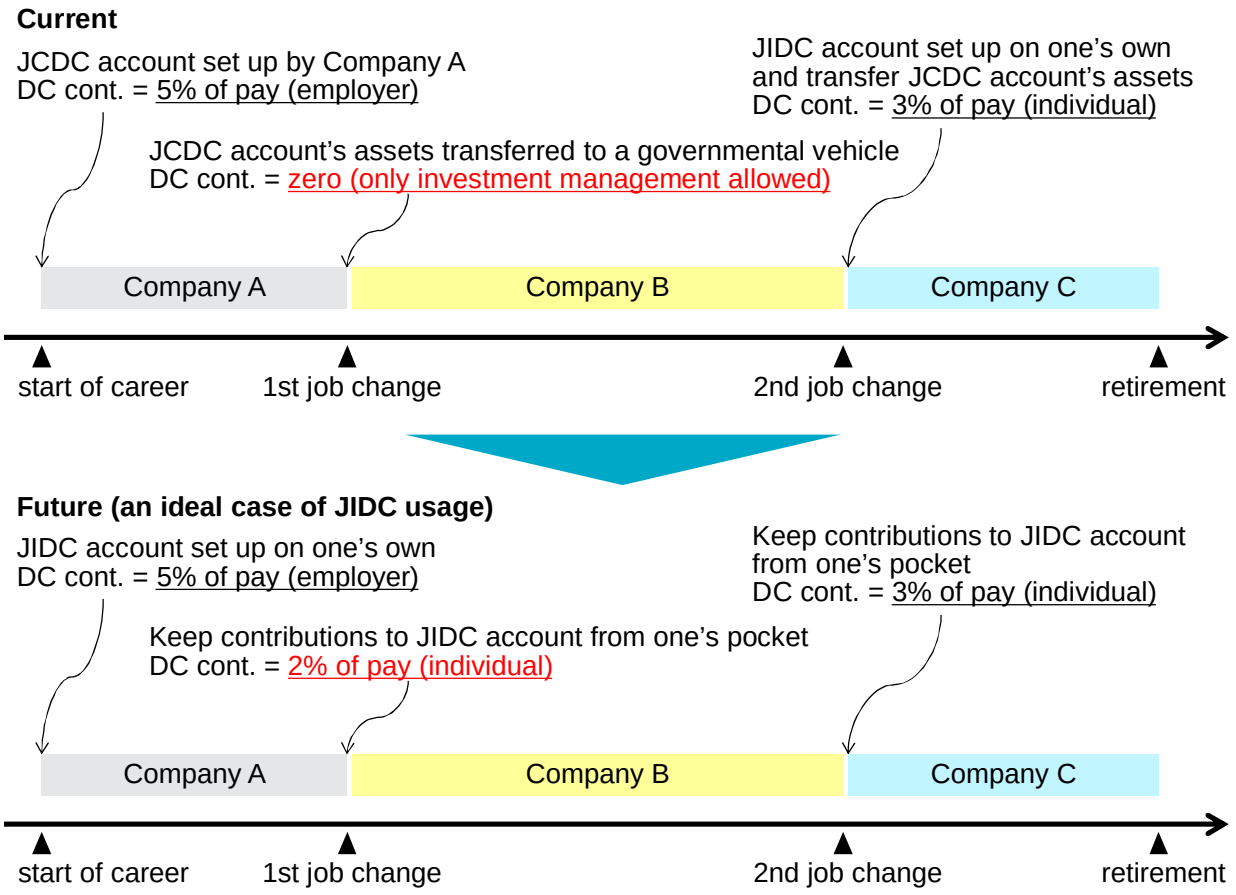

Chart 4.3: Illustration of how portable DC can be used to secure post-retirement income resources

5. A comparison of DC schemes in Japan and the United States

Here Japanese DC provided by private companies is compared to USA DC (also known as 401k) which was a benchmark that was taken into consideration when the Japanese DC laws were developed and enacted. The below is a summary of key features of both DC systems.

While JCDC accumulates assets mainly based on employer contributions, a considerable portion of US 401k assets is ascribed to employee contribution. A typical design of employer contributions is 0.5-2 times matching of employee contribution plus a non-discretionary contribution of 1-5% of pay. As a result, US 401k is securing greater sums of money in a more flexible account compared to JCDC.

When it comes to asset portability, both countries have similar arrangements for corporate-sponsored and individual use as below. Japanese workers enjoy the benefit of portability as described in Chart 4.3 and American workers do in a similar way.

Table 5.1: A comparison of Japan / USA corporate-sponsored DC

	Japan (JCDC)	USA (401k)
History	Since 2001	Since early 1980's
Type	Employer contribution oriented	Employee contribution oriented
Contribution Cap	660 thousand JPY (2014 / Employer)	17.5 thousand USD (2014 / Employee)
Cash Withdrawal	Not allowed until retirement age	Allowed in return for tax penalties
Portability	Encouraged (with limits of coverage)	Encouraged

Table 5.2: Japan / USA DC vehicles

	Japan	USA
Corporate-sponsored plan	JCDC	401k
Individual plan	JIDC	IRA (Individual Retirement Account)

Once the proposal is enacted, the current differences and similarities may be changed (in the mid- or long-term) as follows:

- Japanese DC to be more employee/individual contribution oriented like US 401k is (keep contributing to a JIDC account during one's whole career and accept employer contribution if provided)
- JIDC may be a better platform for portability needs than the current systems in Japan and USA (managing all the money contributed during one's career with one account will cause less asset transfer between accounts and consequent loss of investment, administrative hassles, and procedural fees)

6. Conclusion

More than a decade has passed since Japanese DC laws were initially introduced, and the speed of DC's diffusion has not been high for reasons including the restrictions in contribution amount and coverage. While the contribution caps have been expanded gradually, and the trend is expected to continue in the future, this is the first time that coverage issue has been addressed in legislative updates. This is a

remarkable thing and indicates that the ruling parties and the government would like to increase DC use among the public more proactively.

Having a long history, the current Japanese pension system is facing issues of longevity that were not anticipated at the beginning, and thus concerns of the system's sustainability have recently come to be discussed. To that end, DC (in the form of JIDC) as part of "Vertical Combination" will likely be a good solution as its portability can encourage individuals to consider their retirement savings plan and manage money accordingly so that they can ensure income during a transition period from being in active service to old age, and consequentially financial costs of employment, private pension, and state pension will be balanced better.

In a comparison, US 401k are more flexible in terms of contribution amounts and cash withdrawal due to its individual contribution oriented philosophy while the methods of asset transfer are similar in Japan and USA. It is possible that the proposal will individualize Japanese DC and create a common platform to save money that is more efficient than US 401k/IRA system for asset portability.

Lastly, themes to be investigated further in relation to the points discussed in this paper are:

- <u>Enhancement of non-DC pension benefits' portability</u>
  Japanese individuals are allowed to receive payments upon termination (mostly prior to normal retirement age) from DB type plans when they select to receive the benefits in the form of lump sum, which is fairly-common right now. For the purpose of encouraging individuals to save money as retirement savings, this practice needs to be reconsidered. An alternative is to grant respective "retirement benefit" accounts to individuals so that they can receive any "retirement benefit" including lump sum termination benefit and limit withdrawing money from it more rigorously until retirement age. It may be possible to redesign JIDC to convert its account to the "retirement benefit" account in the future.
- <u>Reconsidering retirement and state pension commencement timing</u>
  "Vertical Combination" allows us to break down post-retirement financial security matters to determination of the period and amount allotted to income resource category (i.e. labor income, private pension, and state pension). This may help the government decide target ages for normal retirement and state pension commencement by quantitative analyses, which will be better than that the government has been increasing both gradually reacting deteriorating public expenditures.

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Appendix – the number of small and medium-sized companies and their employees

Ministry of Economy, Trade and Industry (METI) in Japan present statistics regarding the number of small and medium-sized companies and their employees. The data prepared is based on the following definitions.

Table A-1: Definition of small and medium-sized businesses by METI

Industry	Requirements either of which small and medium-sized companies fulfil	
	Capital Amount (million JPY)	Head-count
Wholesale	Less than 100	Less than 100
Retailing	Less than 50	Less than 100
Service	Less than 50	Less than 50
Others (e.g. Manufacturing)	Less than 300	Less than 300

Table A-2 is a summary of statistics announced by METI in July 2014.

Table A-2: The numbers of small and medium-sized businesses and their employees

	# of companies	# of employees
Small and medium-sized companies	3,853 thousand	32 million
Others (i.e. big firms)	11 thousand	14 million