

## **New Trend of severance and retirement benefits in Japan**

Yoshihiro Oyama

Certified Pension Actuary, Pension Advisory Department,  
Sumitomo Mitsui Trust Bank, Limited  
1-4-1, Marunouchi, Chiyoda-ku, Tokyo 100-8233, Japan  
E-mail: yoshi\_oyama@hotmail.com

### **Abstract**

Defined Contribution (DC) pension plans were introduced to Japan as a new option for retirement income security in 2001. Although not so many employees are covered by DC pension plans compared to Defined Benefit (DB) pension plans until now, it seems that some change will occur in the near future.

Japanese laws and regulations for occupational pension plans changed drastically in 2014. This change will compel the almost all of existing Employees' Pension Funds (EPFs) to be abolished in 5 years. EPFs, which are DB type plans, used to be dominant in the field of corporate pension plans until the beginning of this century. But many big companies changed their EPFs into Defined Benefit Corporate Pension Plans after the enforcement of the Defined Benefit Corporate Pension Act in 2002. As a result, EPFs now covers mainly the employees of Small and Medium-sized Enterprises (SMEs).

Last year's amendment has the possibility to cause the decline in the coverage ratio of occupational pension plans of SMEs' employees. In order to decrease such influences, the Ministry of Health, Labour and Welfare, is trying to make the regulations to be much easier to adopt DB and DC pension plans for SMEs. That is, there may be new trend that more and more SMEs will adopt DC.

As the pension benefits have more importance than the lump sum benefits for old age life even if it is from DC, this direction will be welcomed.

### **Keywords**

Occupational pension plans, DB pension plans, DC pension plans,  
Employees' Pension Fund

## **1. Introduction**

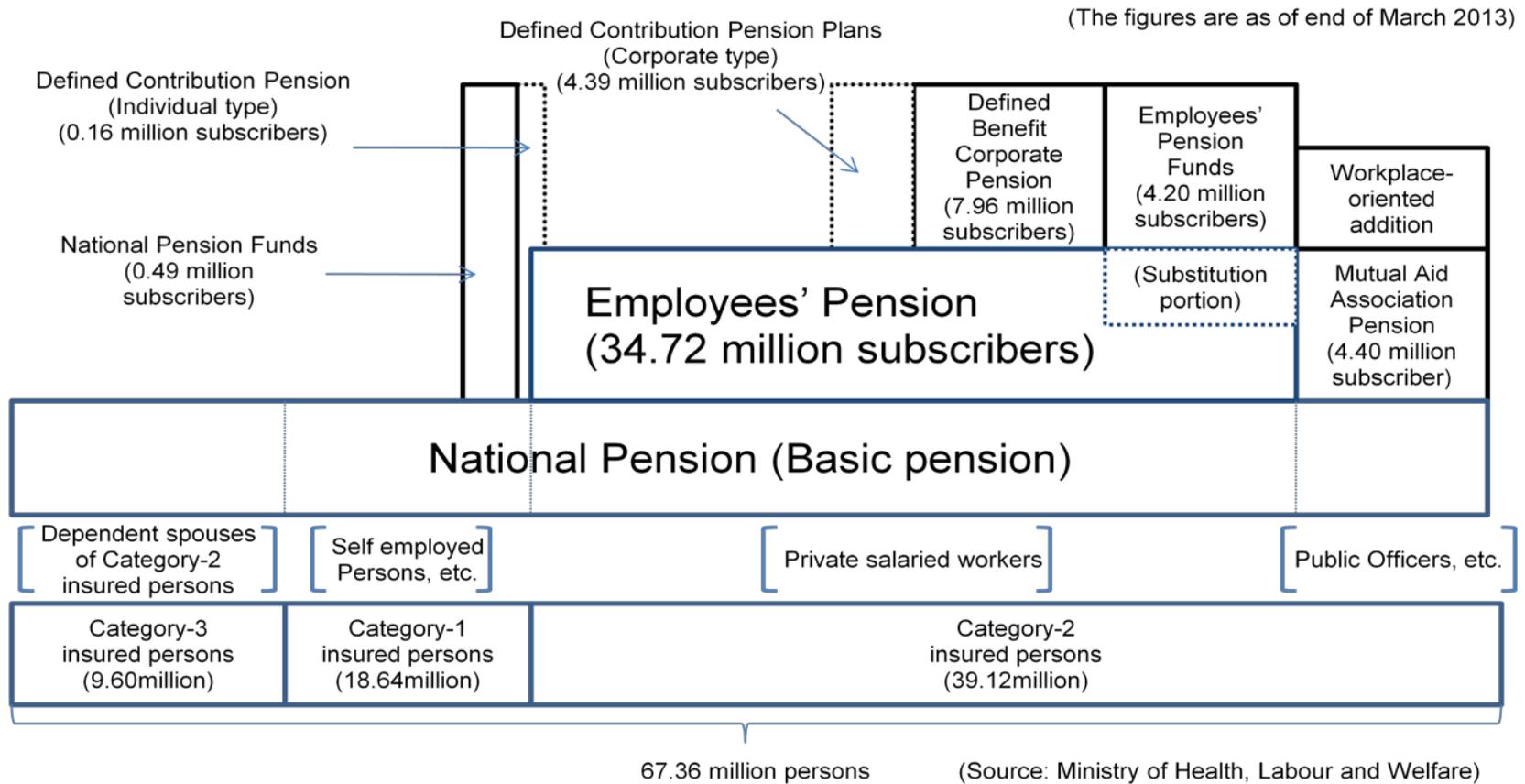
As the Figure1 on the next page shows, not all of Japanese salaried workers in private sector are covered by corporate pension schemes. And the coverage ratio of pension plan declined recently due to the abolishment of Tax Qualified Pension Plans. In addition, almost all of Employees' Pension Funds will vanish in 5 years according to the Amendment of Employees' Pension Insurance Act to secure the soundness and reliability of public pension system 2013.

Authorities are not only breaking corporate pension plans, but also trying to make DC pension plans easier to adopt. This change will be welcomed.

In this paper, I will show the brief history of Japanese employee benefit arrangements, followed by the effect of the change of Tax Qualified Pension Plans. After that are AIJ scandal in 2012, and the new Public Pension Protection Act of 2013, which compels almost all of Employees' Pension Funds to be abolished. I will also show that changes for DC plans by Japanese government are already beginning.

# Figure 1: Overview of Japanese Pension System

- In Japan, every people of working-age population shall be an insured person of National Pension and receive a Basic pension in their older age. (First layer)
- Additionally private company workers and public service employees shall join Employees' Pension or Mutual Aid Pension and receive pension, which are supplemental to the National Pension, in proportion to the individual's remuneration. (Second layer)
- In addition, Employees' Pension Funds, etc. are available at the option of individuals and companies. (Third layer)



## **2. Brief History of the Employee Benefit Arrangements**

In this chapter I will show brief history of Japanese employee benefit arrangements.

### **2.1 Development of the Lump-sum benefits**

In Japan the practice of providing a lump-sum payment at severance or retirement became fairly common in private sector by the early 20th century. It is the most usual measure up to now.

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.

### **2.2 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.

### **2.3 Introduction of Employees' Pension Fund Schemes**

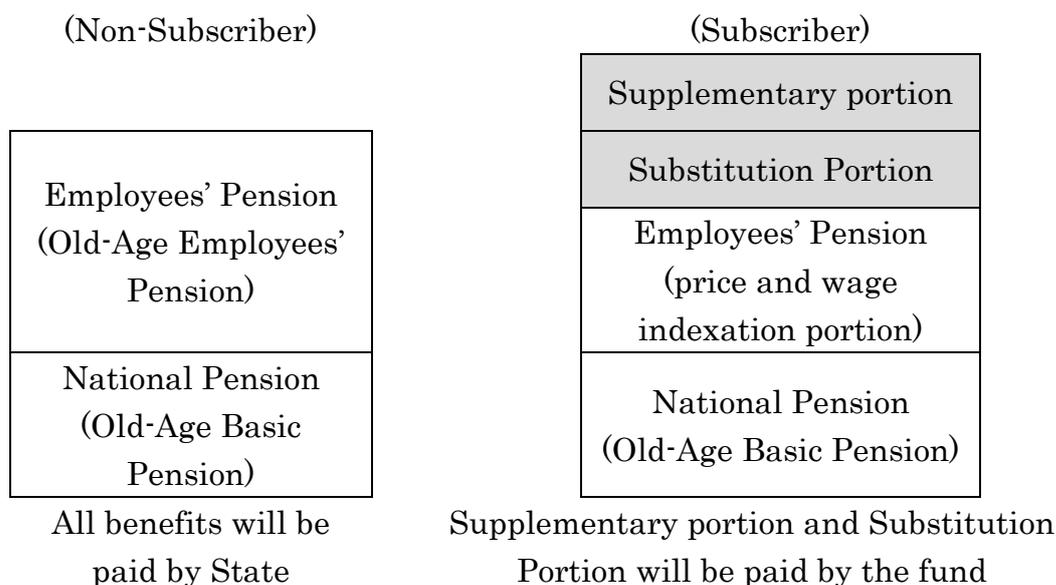
The public pension system for workers in private sector is the Employees' Pension Insurance (EPI). It comprised of two parts, namely fixed amount benefits and benefits payable in proportion to wages.

In 1965, the EPI was amended and an Employees' Pension Fund (EPF) scheme was introduced that replaced earnings-related old age pension

benefits payable by the EPI. In short, EPFs were to assume responsibility for providing 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 substitution portions, EPFs are required to have supplementary portions. Both substitution 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 substitution portion to the entire EPF varies. In some plans, the substitution 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.

**Figure 2: Structure of Employees’ Pension Fund Benefits**



There are three types of EPFs:

- Single-Employer Funds established by a single employer,
- Allied-Employer Funds established by affiliated employers within a group of businesses, and
- 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.

## **2.4 Introduction of Defined Contribution Pension Plans**

In June 2001, both the Defined Contribution Pension Act (DCPA) and the Defined Benefit Corporate Pension Act (DBPA) were promulgated 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. There are 2 types of DC plans:

- Occupational type DC pension plan, which covers employees in private sector, and
- Individual type DC pension plan, which covers:
  - Employees in the private sector without corporate pension plans; and
  - Category-1 insured persons of National Pension (Self-employed persons, etc.)

One major purpose of the DBPA is to introduce a common framework to protect employees' benefit rights covered by DB type corporate pension plans: both EPFs and DBCPPs.

The DBPA provides (1) funding requirements, (2) fiduciary responsibility, and (3) reporting and disclosure. And in conjunction with this, the TQPPs, which provides inadequate funding requirement, were determined to be changed into other plans or abolished by the end of March 2012.

At the same time, EPI was amended to permit each EPF to separate the substitution 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 DBCPP.

## **3. Effect of the change of TQPPs**

As mentioned above, the TQPPs were destined to be changed into other plans or abolished by the end of March 2012. This change deprived of many workers' pension benefit rights in the Small and Medium-sized Enterprises (SMEs).

The DBPA, which had been promulgated in June 2001, became into force on 1 April 2002. There were 73,582 TQPPs which covered 9.17 million workers on the previous day of the enforcement of the Act. In order to comply with the law, employers changed their plans as follows:

- 15,064 plans into DBCPPs,
- 7,747 plans into DCs,
- 123 plans into EPFs, and
- Rest of the plans were converted into lump-sum benefits including the Smaller Enterprise Retirement Allowance Mutual Aid Scheme

These figures show that only one third of employers which had provided TQPPs continued to make pension benefits available to their employees.

The other statistics by the Ministry of Health, Labour and Welfare (MHLW) also show that coverage of corporate pension plans among SMEs declined as follows.

- In 2008, 30.2% of enterprises with 30 to 99 employees have had corporate pension plans, but in 2013, only 18.6% of the same sized companies provided pensions.
- Enterprises with 100 to 299 workers the coverage ratio declined from 51.8% to 36.1% in the same period.

#### **4. AIJ scandal and new Public Pension Protection Act**

An investment advisor, named AIJ, collected more than 180 billion yen from pension funds, but that money vanished by fraud. After this scandal, the government changed the EPI. And almost all of EPFs are now being compelled to change into other plans.

##### **4.1 AIJ scandal**

In 2012, the authorities found the frauds of AIJ Investment Advisors CO., LTD (AIJ). AIJ's clients lost over 180 billion yen by this scandal in total. AIJ's main clients were pension funds. 84 pension funds invested to AIJ's investment funds. 73 of the 84 were Multi-Employer EPFs. And some EPFs invested significant portion of total assets to AIJ, which might not have been complying with the diversification policy in the investment strategy.

## **4.2 The reaction by MHLW**

Since EPFs receive exemption contributions from the EPI, the government considers that there are deposits for the EPI in EPFs' Funds. That amount is named Minimum Reserve, which will be returned to the government when an EPF is abolished or changed into a DBCPP.

After the financial crisis in 2008, the number of EPFs whose assets were less than their Minimum Reserves (in deficit) increased drastically. That means when the EPFs are abolished, possibilities exist that the EPI will not be able to receive the full amount of deposits. That fact made the MHLW cautious of soundness of the EPI.

Under such circumstances, the AIJ scandal in 2012 triggered the reform of the EPI.

## **4.3 New Act**

The Amendment of Employees' Pension Insurance Act to secure the soundness and reliability of public pension system was enacted in June 2013. This new Act came into force on 1 April 2014.

One of the aims of this Act is not to allow EPFs to be underfunded of the Minimum Reserve. It forced almost all of EPFs to change into DBCPP or DC or to be abolished by the end of March 2019. After April 2019, the Minister of the Health, Labour and Welfare will have the power to make order to abolish EPFs that will not meet the financial criteria.

## **4.4 Current Status of EPFs**

There are 531 EPFs that cover 4.2 million employees as of end of March 2014. They are divided into 3 types as follows:

- 27 Single-Employer Funds,
- 38 Allied-Employer Funds, and
- 466 Multi-Employer Funds

More than 80% of the EPFs are Multi-Employer plans which cover mainly the employees of SMEs.

As mentioned earlier, by March 2012 the TQPPs were forced to change into other plans. Facing that requirement, many employers chose lump-sum benefits, which made pension coverage ratio smaller among the employees of SMEs. Such cases can occur again by this New Act.

## **5. Change for DC plans**

Changes for DC plans are already beginning.

### **5.1 Publication of the Committee Report**

Social Security Council in the MHLW organized the Corporate Pensions Committee in October 2013, just after the promulgation of the New Act. The Committee discussed many aspects of corporate pension plans, including the deregulation of plan designing.

On 16 January 2015, the Committee published a report, mainly on items about pension planning that the members had discussed.

One of the discussions was how to enhance the coverage ratio of corporate pension plans in the employees of SMEs. Remarkable proposals in the report were:

- (1) New tax deduction for the contributions to the individual type DC which were paid by small-scale employers.
- (2) Extension of eligibility for participation of individual type DC pension plan, and
- (3) Change of the regulations on maximum contribution to DC plans, from monthly basis to annual basis.

These items have been already adopted in the government's tax reform for FY 2015.

### **5.2 New tax deduction for the contributions**

Under current system, when a company makes a corporate type DC plan, employer has a responsibility to conduct education on investments for its employees. This burden can be sometimes a tall order for an SME. And if a worker who is working for a company without a pension plan wants to participate in a DC plan, he or she has no choice but go to individual type. In this case, that employee can't get contributions from its employer.

New tax deduction for the contributions to the individual type DC which were paid by small-scale employers will make it possible for the participants of individual type DC to receive increased pension benefits. It is a very good change for both employers and employees.

### **5.3 Extension of eligibility for DC**

The government admitted the extension of eligibility for participation of individual type DC pension plan to include:

- Dependent spouses of private salaried workers and public officers,
- Participants of corporate type DC plans, DBCPPs and EPFs; and
- Participants of Mutual Aid Association Pension (public officers).

This change may not directly affect the coverage ratio of DC for the employees of SMEs. But if a dependent spouse of an employee participates in the DC plans, the household income of that family will increase. It will result in a good welfare.

### **5.4 Change of the regulations on maximum contribution**

For example, maximum contribution amount for corporate type DC plan for the employees without EPF or DBCPP is now 55,000 yen per month. It means that if the contribution for a participant failed to be paid for one month, that amount will never be used in the future period. That is, if a failure occurs for one month, the maximum yearly amount will change from 660,000 yen (= 55,000 X 12 ) to 605,000 yen (= 55,000 X 11).

Change of the regulations from monthly basis to annual basis eliminates such inconvenience.

### **5.5 Other discussions**

The committee's report proposed other measures to make it easier for SMEs to have pension plans for their employees.

Such means include for example:

- Introduction of collective DC plan.
- Education on investments by outsiders for DC participants.

The authorities have not adopted these ideas yet. Continuous discussions on plans are desirable.

## **6. Concluding remarks**

Easing the procedure of making DC pension plans is welcome.

As shown in above, the abolishment of the TQPPs diminished the coverage ratio of corporate pension plans among the employees of SMEs. And in the near future, it is considered that almost all of EPFs will fade out. In such circumstances, without effort to promote easily installable DC plans,

pension coverage in SMEs may decline rapidly. Tax reform for FY 2015 is the first step for an effort for adopting DC plans.

As the pension benefits have more importance than the lump sum benefits for old age life even if it is from DC, this direction will be welcomed.

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