Assessing Private Pension Plan Regulation in Japan
-- Comparison with the OECD Recommendation on Core Principles of Occupational Pension Regulation --

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This paper examines the regulation and legal practices of Japanese private sector pensions and compares them to the OECD Recommendation on Core Principles on Occupational Pension Regulation (2004).

There are four sections. Section 1 is an overview of occupational retirement benefits in Japan. Section 2 explains the current regulation and legal practices of Japanese retirement benefits, and Section 3 compares these to the OECD Core Principles by focusing on their commonalities and differences. Finally, Section 4 makes recommendations for both Japanese regulation and the OECD Core Principles.

SECTION 1. Introduction—Overview of occupational retirement benefits in Japan

This section overviews the occupational retirement plans in Japan—severance benefits, defined benefit pension plans, and defined contribution pension plans. We explain and compare the characteristics of each type. We then discuss the prevalence by plan type after the reforms of 2001.

1. 1. Comparison of benefit schemes

In Japan, on top of the two public pension schemes (fixed-amount benefit of the National Pension Insurance (NPI) scheme, and earnings-related benefit of the Employees' Pension Insurance (EPI) scheme), employers in the private sector[1] also provide their own retirement benefits in three forms—severance benefits, defined benefit pension plans, and defined contribution pension plans.

Severance benefits refer to the lump-sum benefit that employers pay out to employees upon termination of employment. It is the original and traditional form of retirement benefit in Japan, and still the most prominent at employers of most sizes. The funding source of the severance benefit is the employer's book reserve, which means that employers do not accumulate any external assets to defray benefit costs. The average benefit amount per employee with more than 30 years of service at a single employer is 10 to 30 million yen, which is equivalent to 30 to 50 times the final monthly salary.

Defined benefit pension plans with tax-qualified status can be broken down into four categories—Employees' Pension Fund (EPF)[2], fund-type defined benefit corporate pension, (fund-type DBCP), contract-type defined benefit corporate pension (contract-type DBCP), and tax-qualified pension plan (TQPP).

The main difference between EPFs and other three types is that the EPF has a substitution component, where the EPF collects part of the contribution to the EPI public pension, and pays out an annuity corresponding to that part. The difference between TQPPs and DBCPs is that supervision and regulation pertaining to TQPP establishment and maintenance are more lenient than those for DBCPs.

Most defined benefit plans are non-contributory for employees, except for the EPF substitution component. Pension plans generally pay out an old-age annuity or lump-sum benefits

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[1] For pubic sector employees, the respective government body provides unfunded severance benefits. On top of that, mutual insurance organized by local and national governments respectively provides for pension plans, partly as a substitute of EPI and partly as an additional occupational pension.

[2] There are three types of EPFs—a single employer plan, a multi-employer plan established by affiliated employers, and a multi-employer plan established by employers in the same region or industry.

after retirement.[3] Usually, employers give employees the option to choose between an annuity[4] and lump sum.

For defined benefit plans, it should be noted that working conditions stipulate not only the amount of pension and severance benefits but also the total amount of retirement benefits—that is, the present value of the annuity plus the amount of severance benefit. If the present value of the defined benefit plan annuity increases (decreases), then the amount of severance payment must decrease (increase) by the same amount.

For example, if a defined benefit plan is terminated with a funding shortfall and plan benefits are not fully paid out, employees can demand that the employer increases the severance benefit by the same amount, even in case of employer bankruptcy. Also, if employment is terminated before the vesting of pension benefits, the severance benefit will be increased to partially compensate for unpaid pension benefits.

As for tax-qualified defined contribution plans sponsored by employers, the employer contributes either a fixed amount or fixed percentage of wage to each employee's account. Employees cannot make any contributions, but similar to DC plans in other OECD countries, they can choose the investment vehicle and must assume investment performance risk.

1. 2. Prevalence and trends by plan type

Table 1 shows the prevalence rate of benefits by plan type and employer size as of January 2003. Overall, 86.7% of all employers provide retirement benefits of some form—69.7% provide severance benefits, and 46.4% provide pensions. By type of pension, 21.6% of employers provide EPFs and DBCPs, 30.5% provide TQPPs, and 0.8% provide DC plans.

<Please insert Table 1 here>

While severance benefits are generally more prevalent than pension plans, the situation varies by employer size. At large employers with 1,000 or more employees, 86.4% have pensions and 78.6% have severance benefits. However, severance benefits grow more prevalent than pensions as employer size declines. By comparison, at small employers with 30-99 employees, 69.2% have severance benefits and only 38.9% have pensions.

Table 2 shows trends in the number of plans and active participants since 2003. A comprehensive reform of corporate pensions was undertaken with the implementation of two new laws in 2001 and 2002. The Defined Contribution Pension Law of 2001 gives tax exempt status to defined contribution pension plans[5]. The Defined Benefit Corporate Pension Law of 2002 stipulates that existing TQPPs be terminated or frozen by 2012, or else lose their tax-qualified status.[6] If not terminated, TQPPs can be reorganized as a DBCP or DC, or else join the Retirement Allowance Mutual Aid for Small and Medium Enterprises.[7] The law also allows EPFs to be converted into

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[3] If employment is terminated before the pension is vested, then the EPF, DBCP and TQPP will pay out a lump-sum severance benefit.

[4] The perpetual annuity is not a very common form of benefit among pension plans except for EPFs, where the provision of a perpetual annuity is mandatory.

[5] The Defined Contribution Law of 2001 gives tax-qualified status to two types of schemes—the corporate-type, which is explained here, and the individual-type, for which eligibility is given to private-sector workers whose employers do not sponsor any tax-qualified pension plans, and to self-employed workers.

[6] The National Tax Agency has not allowed any registration of new TQPPs since then.

[7] Retirement Allowance Mutual Aid for Small and Medium Enterprises is an externally funded scheme for retirement benefits at SMEs, managed by an independent administrative agency called the Organization for Workers Retirement Allowance Mutual Aid under the supervision of MHLW. Under this scheme, small and mid-sized employers commit to contribute 5,000 to

DBCPs by returning the substitution component back to the public pension scheme. As Chart 1 shows, the reforms drastically increased the options for employers regarding benefit forms.

The reforms contributed to growth in the number of DBCPs and DC plans and decrease in EPFs and TQPPs. In March 2004, EPFs outnumbered DBCPs by 4-to-1; at the end of March 2007, the ratio of EPFs to DBCPs had reversed to 1-to-3. Meanwhile, the number of DC plans has steadily increased from 70 to 2,319 over the last five years. By comparison, the number of TQPPs has decreased 42% during the same period.

Table 2 also shows changes in the number of active participants by plan type up to March 2007. EPFs are the largest at 5.2 million participants, followed by TQPPs at 5.1 million participants, DBCPs at 4.3 million participants, and DCs at 2.2 million participants. Due to double and triple counting, the actual coverage of pension plans is estimated at 11 to 15 million participants, or approximately 40% to 50% of the 30 million regular workers in the private sector.[8]

<Please insert Table 2 and Chart 1 here>

SECTION 2. Regulation and Legal Practices of Japanese Pensions (ref. OECD Core Principle 1)

This section explains the current regulation and legal practices of Japanese pensions in reference to and in the order of the six clauses of the OECD Core Principles (2004). The final part explains the laws and regulations related to pension fund governance.

2. 1. Conditions for effective regulation and supervision (ref. Core Principle 1)

- Japan's capital markets are among the world's most developed markets and offer vast and diversified investment opportunities for pension funds. There is no restriction on cross-border flows of capital.
- Laws and rules on disclosure, corporate governance, fair trading, financial accounting and financial institution operation are at least no less well organized and effective than in other OECD countries.
- For example, the treatment of severance benefits and defined benefit plans in financial accounting are similar to the treatment in International Accounting Standard 19. Liabilities are evaluated by the projected unit method. The discount rate is set in reference to the market yield of high-grade bonds in the last five years. Other actuarial assumptions are decided by consultation among employers, accountants and actuaries. Actuarial differences, past service liabilities and transition obligations can be smoothed over several accounting periods, usually over expected remaining service period for average employees.
- All of the tax-qualified pension funds—EFPs, DBCPs, TQPPs and DCs—are regulated and supervised by government authorities empowered by special laws applied to each type of pension plan. EPFs, DBCPs and DCs are regulated by the Minister of Health Labor and Welfare (MHLW). TQPPs are regulated under income tax laws by the National Tax Agency of the Ministry of Finance. On the other hand, severance benefits are subject to laws and regulations on wages and other working conditions in general.

30,000 yen per month to each employee's account held at the organization. The organization manages and invests the account assets, guaranteeing a minimum rate of return, and distributes the assets to employees upon job termination. At the end of March 2007, 2.8 million workers at 382,436 enterprises are covered by this scheme.

[8] Including part-time and temporary workers of 15million, who are rarely covered by retirement benefits, the total number of workers in the private sector is estimated at 45 million persons.

- Financial contractors who play important roles in pension management—such as life insurance companies, trust banks, and investment advisory firms[9]—are also regulated by the Financial Services Agency. As a result, pension funds are protected from illegal measures of financial contractors.[10] MHLW are supposed to impose punitive sanction in case financial contractors disobey the fiduciary responsibility that pension laws demand of them.
- The Financial Services Agency supervises the financial situation of life insurance companies by using several indicators such as the solvency ratio,_which reflects risks associated with the management of asset and liability value .
- By comparison, MHLW supervision of DB funding ratios encompasses only the simple funding ratio (ratio of value of assets to liabilities), which does not consider future volatility or risks of investment and asset liability mismatch. MHLW does not require any margin for such risks, since the employer is supposed to pay additional contributions to absorb any shortfalls resulting from risk-taking activities.

2. 2. Establishment of pension plans, pension funds, and pension fund management companies (ref: Core Principle 2)

2. 2. 1 Severance Benefit

- Provision of the severance benefit is voluntary. Employers can establish, manage and terminate the severance benefit as part of their human resource management operations. No special scheme or entity is required to establish or manage this benefit. All the conditions for an employer to establish severance benefit is to reach agreement with representatives of the majority of employees or of the labor union if one exists. The agreement with the labor union constitutes part of the collective agreement.
- Once established, rules on the severance benefit are included in the written working rules. Employers with at least ten employees must submit general working rules to the local Labor Standard Inspection Office, which is under the jurisdiction of MHLW.[11]
- Working rules submitted to the Labor Standard Inspection Office must include the following terms regarding the severance benefit:
  (a) eligibility for benefits;
  (b) rules determining the benefit amount and payment method, and definition of factors such as vesting, tenure, reason for severance, reason for reduction and/or elimination of benefit, and form of payment (cash or bank transfer, lump-sum or installment), and
  (c) timing of benefit payment after severance.
- The agreement on severance benefit is subject to laws and regulations on wages and other working conditions in general, which include non-discriminatory rules and the restriction of amendments that are disadvantageous to employees. Other than that, there are no specific restrictions on how employers manage and operate these benefits, since severance benefits are

[9] An MHLW ministerial order states that EPFs and DBCPs must entrust their actuarial calculation to those contractors designated by MHLW.

[10] For example, the new Financial Product Transaction Law, which takes effect in September 2007, obliges financial contractors to disclose and explain product terms in written form to investors in general. These obligations do not apply with respect to those pension funds that choose to register as professional investors. And as professional investors, those pension funds can invest in specialized products such as privately issued securities.

[11] The Labor Standard Law, Art.89.

managed as part of the employer's operation.

2.2.2 Employees' Pension Funds (EPFs) and Fund-type Defined Benefit Corporate Pensions (DBCPs)

- EPFs are independent and separate entities from the employer. To set up an EPF, the Employee Pension Insurance Law requires that employers first reach an agreement with the majority of employees and any labor union representing one-third or more of employees if such a union exists, formulate plan bylaws, and then have the bylaws authorized by MHLW. Items that must be included in the bylaws are listed in Table 3.
- EPFs have their own board of directors, managing directors and staff, and conclude a contract with a financial services contractor—a trust bank, life insurance company, or agricultural mutual insurance company. Contractors perform services such as contribution collection and benefit payment, plan administration, and asset management and custody. EPFs are under contractual obligation to pay in all contributions to financial contractors for the purpose of benefit distribution, and in turn can demand that employers pay contributions in accordance with bylaws and legal requirements.
- To establish a fund-type DBCP, employers are required to reach an agreement with any labor union representing the majority of employees, or representatives of the majority of employees if such a union does not exist, and formulate bylaws and obtain MHLW authorization. Required items in the bylaws are mostly the same as for EPFs.(Table 3)

<Please insert Table 3 here>

- EPFs and fund-type DBCPs have the same governance structure. The employer and employees both elect the same number of representatives, who in turn nominate the same number of members to the board. One board member from the employer's side serves as chairperson, and nominates managing directors. Representatives of the employer and employees each select one of the two auditors. There is no qualification requirement for directors or auditors. Most of them are current or former employees.
- Board members and managing directors as well as financial contractors are considered to owe fiduciary responsibility consisting of duty of loyalty and care.[12]

2.2.3 Contract-type DBCPs

- The establishment process Contract-type DBCPs is similar to fund-type DBCPs. Employers must reach an agreement with any labor union representing the majority of employees, or representatives of the majority of employees if such a union does not exist, and then formulate plan bylaws. For the plan to commence, the Minister of Health Labor and Welfare must approve, as opposed to authorize, the bylaws.
- The content of contract-type DBCP bylaws, also shown in Table 3, is shorter than that of fund-type DBCP bylaws. There are no boards, directors or auditors. The employer—not the fund—enters into contracts regarding contribution and benefit payment, plan administration, and asset management and custody.
- Contract-type DBCPs are not independent legal entities, but instead managed as part of the employer's operation in cooperation with financial contractors, while assets under the management of financial contractors are separate from the employer.

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[12] Under duty of care, fiduciaries must discharge their duties prudently. While pension-related laws do not provide duty of care explicitly, directors of EPFs, and fund-type DBCPs, and employers with contract-type DBCPs, TQPPs, and DCs, and financial contractors are considered to owe this duty by the application of the Civil Code Art.644 and 645 to the contract of entrustment or mandate. See Morito (2004).

2. 2. 4 TQPPs

- The establishment process of TQPPs is simpler than that of contract-type DBCPs. After obtaining an agreement with the majority of employees, the employer concludes a TQPP contract with a financial contractor, which can be a trust bank, life insurance company, or agricultural mutual insurance company. Financial contractors implement a self-assessment process by confirming the contract terms, as follows:
  (a) the purpose of establishment is to provide retirement benefits,
  (b) the form of TQPP contract is one of three types (trust, insurance, agricultural mutual insurnace),
  (c) the employer's board of directors do not participate in the plan,
  (d) the discount rate is not changed except upon actuarial recalculation,
  (e) the assumptions and methodology used in actuarial (re)calculation are appropriate,
  (f) contributions are either a fixed amount or fixed percentage of wage, or calculated in a similar manner,
  (g) past service liability or other shortfall is compensated in the way prescribed in advance,
  (h) any surplus over pension liability at the time of recalculation is paid back to the employer,
  (i) as long as accumulated assets are less than or equal to total pension liabilities, they cannot be returned to the employer,
  (j) upon termination of the TQPP contract, funds returned from financial contractors are paid back to participants,
  (k) the benefit amount is not reduced unless unavoidable reasons exist,
  (l) no employees are unduly discriminated against in treatment by TQPPs,
  (m) financial contractors must not extend loans to employers at favorable conditions, and
  (n) sustainability and stability of the contract is secured for a certain number of years.
- After completing the self-assessment, financial contractors apply for registration at the National Tax Agency. The registration activates the tax-qualified status of the pension plan.
- As with contract-type DBCPs, the TQPP is part of the employer's operation, in cooperation with financial contractors. There are no their own boards, directors or auditors.

2. 2. 5 DCs

- The Defined Contribution Plan Law requires employers to take the following steps to establish a DC pension plan. First, the employer must reach a collective agreement with the majority of employees and any labor union representing one-third or more of employees if such a union exists. Second, the employer must formulate plan bylaws for approval by the Minister of Health Labor and Welfare. Items to be included in the bylaws are listed in Table 3.
- Next, the employer must conclude a contract with financial contractors for plan administration and management as well as custody services. Financial contractors performing administrative and managerial service are called DC plan administrators, and those performing custody services are called DC plan trustees. Plan administration and management services are separated into a record keeping service and investment related service, each of which is usually performed by different contractors.
- ＤＣ plans are part of employer's operation and managed in cooperation with financial contractors. DC plans themselves do not have any independent legal existence.

2. 3. Pension plan liabilities, funding rules, winding up, and insurance (ref. Core Principle 3)

2. 3. 1 Severance Benefit

- Under Japanese labor law, the severance benefit cannot be legally claimed unless employment is terminated. This differs from the treatment in accounting principles of financial reporting, where

accrued benefits are regarded as liabilities and recorded from the commencement of employment.

- Labor law calls on employers to try to secure a benefit payment capacity at least equal to: (a) one-fourth of benefits to be paid in the case of voluntary severance of all employees, (b) the amount of benefits that would be paid if the employer is a member of the Retirement Allowance Mutual Aid for Small and Medium Enterprises, and (c) the amount agreed upon by labor and management. To this end, employers are required to prepare and implement one of the following measures:
  (a) financial institutions' guarantee of benefit payment,
  (b) trust arrangement of funds, or
  (c) establishment of committee to secure the payment of retirement benefits.
- However, there is no legal sanction or penalty to enforce this requirement. Employers are under obligation only to "make efforts" to take the foregoing measures. Also, employers are exempt from this obligation if they establish and maintain a funded scheme such as EPF, DBCP and TQPP, or if they are a member of the Retirement Allowance Mutual Aid for Small and Medium Enterprises.
- Employers can terminate a severance benefit scheme on the condition that they amend the working rules with the agreement of the majority of employees. By satisfying the same conditions, they can also alter the level and rules of benefit payment.
- An employee can contest the legal validity of these changes in court. Courts appraise the legitimacy using the rule applied to changes in working conditions in general, which takes into account factors such as the necessity of changes, the negotiation process, alternative compensation and transitional measures, and social perception.
- Severance benefits can also be terminated when employers become bankrupt. As Stewart (2007) explains, claims for severance benefits[13] are treated differently depending on law being applied. If employers are reorganized under the Corporate Reorganization Law, one-third of an employee's claim for severance benefits up to six times the monthly compensation is given priority over the employers' other debts, including collateralized debt and tax payments.[14]
- If the reorganization process is based on the Bankruptcy Law, an employee's claim for severance payment up to three times the monthly compensation is given priority as a superior obligation[15] but subordinated to collateralized debt.
- If an employer's debt is reorganized under other general bankruptcy laws such as the Civil Rehabilitation Law, all benefit claims are given priority over general non-collateralized debt.
- In all of the foregoing cases, a portion of severance benefits and accrued but unpaid wages is guaranteed by the government. The maximum guaranteed amount is 2.96 million yen for workers age 45 and over, 1.76 million yen for workers age 30 to 44, and 0.88 million yen for workers under age 30. The amount cannot exceed 80% of total unpaid wages and severance benefits combined.[16]
- In return for the advance payment, the government has a claim on the trustee of the bankrupt estate. The guarantee is funded by the labor insurance special account, which also includes

[13] Usually, employees can claim unpaid pension benefits as part of the severance benefit because labor and management have agreed on the total amount of retirement benefits. However, in the bankruptcy process, as a practical matter, the effectiveness of this claim is doubtful.

[14] Claims for severance benefits are included in the 'Claims of Common Interests'.

[15] Superior obligations can be redeemed at any time during bankruptcy process.

[16] See the Law concerning Security of Wage Payment etc., Article 5.

workman's compensation and unemployment insurance.

- In fiscal 2005, 42,474 employees applied for 18.4 billion yen of guaranteed compensation. But both the total amount and amount paid per employee are far from sufficient to compensate for lost wages and severance benefits.

2. 3. 2 EPFs and fund-type DBCPs

- In the case of EPFs and fund-type DBCPs, pension assets are separated from those of the employer, and can be expended only for the purpose of benefit payment to plan participants.
- These pension plans have two funding standards—going-concern basis and termination basis. The going-concern basis defines the minimum level of funding as:
  (Present value of future benefit payments) − (Present value of future normalized contributions).
  The minimum level of funding for the termination basis is the present value of future benefits accrued by past service and effectively vested.
- For both defined benefit pensions, employers are obliged to verify the financial situation at least once every five years, and compensate for asset shortfalls from the level stipulated in the funding rule. For the going-concern basis, the employer must replenish the funding shortfall by a fixed amount over a period of 3 to 20 years, or by a fixed percentage from 15% to 60% of the shortfall annually.
- Termination-basis funding requires employers to replenish the shortfall and recover 90% of the current minimum funding level within 10 years[17] [18], or else formulate and execute a recovery plan so that assets exceed 90% of the minimum funding requirement at some point during the next seven years.
- In assessing plan funding conditions, assets and liabilities are valued pursuant to the rules set by the MHLW. Asset value must be based on economic value or fair market value, but employers can use the smoothed value in the last several years for the going-concern basis rule.
- With regard to actuarial assumptions, MHLW sets the minimum discount rate for the going-concern basis rule. MHLW also sets the average discount rate for the termination-basis rule. Upon consultation with a professional actuary, pension funds can use a discount rate that is 0.8 to 1.2 times the average rate. Pension funds can also adjust the standard mortality rate set by MHLW for the going-concern basis. For the termination basis, the mortality table is set by MHLW.
- There is also a maximum limit for plan asset accumulation. If the value of assets exceeds 150% of the termination-basis minimum funding liability, employers must suspend contributions.
- At the time of plan termination, employers must fulfill the termination-basis funding requirement. However, there are three exceptions. First, bankruptcy may make it impossible for employers to replenish the shortfall completely. Claims on employers do not have any preferential status in the bankruptcy process except for contributions of employers to EPFs, which have the same priority status as tax claims and have the priority over general claims.
- Second, upon plan termination as well as plan continuation, the level of benefits including those accrued for past service can be reduced with the consent of any labor union whose membership exceeds one-third of employees if such a union exists, and from two-thirds of all employees, and if one of the following conditions exists:

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[17] In addition, employers are under obligation to replenish funding shortage from 80% of minimum funding requirement within five years.

[18] If pension fund assets exceed 80% of the minimum funding requirement and exceeded 90% in at least two of the last three years, the pension fund is exempt from the obligation to replenish the shortfall.

(a) amendments to the collective bargaining agreement;
(b) deterioration in the employer's business conditions, making benefit reduction inevitable;
(c) employer's contribution is expected to exceed the employer's funding capacity;
(d) consolidation and merger between EPFs and/or DBCPs;
(e) amount of reduction of the employer's contribution is allocated to newly established DC plans; or
(f) transfer of plan assets and benefit liabilities from terminated TQPPs.

- Even the benefits to current beneficiaries can be reduced if two-thirds of beneficiaries agree to the reduction. The reason for this reduction must be (b) or (c) above in the case of DBCPs, or because reduction is inevitable for plan continuation in the case of EPFs. EPFs and DBCPs must then pay the amount equal to the termination-basis minimum funding liability to those beneficiaries who elect to receive that amount in lump sum instead of a reduced annuity. The foregoing reductions of benefit level leads to the lowering of the minimum funding hurdle.
- Third, if only EPFs with a funding shortage are terminated, the Pension Fund Association (PFA) stands ready to guarantee a certain portion of the EPF voluntary component but not the substitutional component. This is because EPFs cannot be terminated unless they make a contribution to pay the substitutional component.
- This benefit guarantee scheme, which was established in 1989 and is funded by insurance premiums paid by all EPFs, does not have a very prominent record. The ratio of EPFs aided by this scheme in all terminated EPFs is below 10%.[19] If EPF termination with a funding shortfall is the result of serious negligence, PFA will reject payment. The maximum benefit guarantee is 100% of voluntary benefits up to 0.3 times the substitutional component and 50% of benefits exceeding that line (Chart2). These factors have made the role and existence of the guarantee scheme relatively small.[20]

<Please insert Chart 2 here>

- The surplus at the time of termination is distributed among participants including retirees. Asset reversion to employees is not allowed.

2. 3. 3 Contract-type DBCPs

- Rules regarding contract-type DBCP's liabilities, funding and winding up are the same as those applied to fund-type DBCPs. The only difference is that employers, instead of pension fund organizations, are directly responsible for abiding by those rules.

2. 3. 4 TQPPs

- Plan assets are under the control of financial contractors. Creditors of employers have no claim on plan assets.
- The minimum funding standard for TQPPs is only the going-concern basis. Employers and financial contractors must verify whether the value of plan assets exceeds the minimum funding level at least once every five years. Pension actuaries working for financial contractors determine the value of plan assets and liabilities. In the valuation process, the discount rate level must be no lower than the standard set by the Minister of Finance through the National Tax Agency.

[19] If employers are generating a profit or in healthy financial conditions when the plan is terminated, this scheme does not guarantee benefit payments. The insurance premium of the guarantee system is composed of three parts—the first is proportional to the number of plan members, the second to the amount of pension obligations, and the third to the amount of unfunded obligations.

[20] Because of this limited coverage, the guarantee scheme has recorded a surplus in 10 of the 12 years since establishment.

Any other assumptions must be based on rational grounds.

- Employers are under obligation to replenish any funding shortfall. The contribution must be less than 35% of the existing shortfall. If the surplus was found as the result of actuarial recalculation, the surplus is appropriated to future contributions or reverted to the employer.
- At the time of plan termination, employers must compensate for any asset shortfall relative to the present value of benefits accrued from past service. But the same two exceptions apply as in the case of EPFs and fund-type DBCPs. Claims from pension funds for employer contributions do not have preferred status in bankruptcy proceedings. Also, benefits can be reduced if similar conditions as above including the labor management agreement and compelling reasons are satisfied. If there is an asset surplus at the time of termination, the surplus is reverted to the employer. The amount is treated as the employer's taxable profit.

2. 3. 5 DC s

- In DC plans, while there is no pension liability, employers are under obligation to pay contributions as stipulated in the bylaws and custody contract to each participant's account held at the plan trustee.
- Tax law stipulates a maximum tax-deductible contribution of 276,000 yen per year if an employer has one or more tax-qualified defined benefit plan, and 552,000 yen if an employer has no other tax-qualified defined benefit plan.
- It is possible for employers to decrease the periodic contribution amount, provided that the amendment is agreed to by labor and management and approved by MHLW.

2. 4. Asset management (ref. Core Principle 4)

2. 4. 1 Severance Benefit

- Since severance benefits have no separate funding, asset management practices are not the focus of discussion here.

2. 4. 2 EPFs and fund-type DBCPs

- Laws and ministerial orders related to these pension funds as well as to their financial services are enforced in the field of investment management. In addition, MHLW has issued interpretational guidelines on related laws.
- Directors and auditors engaging in asset management owe the duty to act with loyalty to the fund and with prudent care. As a matter of course, they must obey laws, plan bylaws and resolutions of representatives' meetings and board meetings.
- Laws prohibit directors from conduct that will hinder appropriate investment management with the intent to promote their own interests and/or the interests of third parties. This clause is intended to prevent behavior causing conflicts of interest. Ministerial orders and interpretational guidelines list specific prohibited conducts such as selecting investment managers for their own interests or that of employers.
- As for application of the duty of care, EPFs and DBCPs are explicitly required to invest in diversified assets with prudent care.
- Laws demand that these pension funds formulate a basic investment policy that covers the following items:[21]
  (a) purpose of investment management
  (b) goal of investment and funding

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[21] Small EPFs and DBCPs with the number of members less than 300 and the amount of asset less than 300 million yen are not obliged to formulate this policy.

(c) asset composition
(d) selection of investment management firms
(e) contents and methodology of reporting on investment results
(f) evaluation methodology of investment management firms
(g) rules to be followed in performing investment management, and
(h) other items necessary for investment management.

- An MHLW ministerial decree also stipulates that these funds specifically appoint a managing director to perform the task of investment management. That managing director should be a person with knowledge about pension plan financial conditions and the capacity to perform their duties properly.
- In order to fulfill fiduciary responsibility properly, interpretational guidelines indicate that it is desirable to establish an investment management committee to support the managing director. The guidelines also suggest that the directors engaged in investment management should try to attain knowledge about investment theory, institutional arrangements, composition of investable assets, and environment for investment.
- Laws and ministerial decrees also stipulate that EPFs and fund-type DBCPs must make efforts to formulate asset allocation policy and to employ a person who has capability necessary for that formulation. Also, in the formulation process of asset allocation policy, EPFs and fund-type DBCPs are encouraged to take methods to achieve the required rate of return while restraining the volatility of assets and liabilities within a tolerable range.
- Directors who breach the foregoing duties must indemnify jointly and severally the losses caused by such conduct to EPFs and DBCPs. They can be replaced by the resolution of representatives' meetings. EPFs and DBCPs can also be imposed with administrative sanctions by MHLW.
- Financial contractors who take care of investment management and custody business are also under the duty to act in accordance with relevant laws and contracts, solely in the interest of pension funds, and with due care. They must indemnify losses caused by the negligence of the foregoing duties to EPFs and DBCPs.
- Investment activities of EPFs/DBCPs take the form of trust or insurance contracts with outside contractors. They can also utilize investment management firms under these contracts. If those pension funds try to manage assets in-house by themselves, they must have (a) a managing director exclusively engaged in investment activities, (b) explicit basic investment policy, and (c) investment staff who have expertise in and familiarity with investment activities.
- The categories of assets to be invested in are not restricted by laws. Investment in alternative assets such as private equity, hedge funds and real estate is allowed as long as they are not in the breach of duty of care and loyalty as prudent investors.
- Derivative transaction such as futures, options and swaps is also permitted. Investment in products incorporating derivatives indirectly is very common among pension funds. It usually takes the form of investment in securitized beneficiary rights of trust arrangement.
- In case of in-house investment, the use of derivatives is restricted to hedging volatility of cash assets and/or rebalancing asset allocation. Also, investment must take the form of investment in securities as defined in Securities and Exchange Act.

2. 4. 3 Contract-type DBCPs

- In contract-type DBCPs, employers as well as financial contractors owe fiduciary duty of loyalty to participants and duty of care. The difference from EPFs or fund-type DBCPs is that there are no individual directors of pension funds who owe responsibility to pension funds.
- Employers must perform investment activities with loyalty to plan participants and with due

care. They are prohibited from acting for their own interests or of third parties when they conclude investment management and/or custody contracts, or direct how assets are managed.

- Laws require employers to perform investment activities with prudent care. They must formulate an investment policy with the same content as in the case of EPFs/DBCPs. Employers are explicitly required to invest in diversified assets with prudent care.
- Employers must abide by laws, ministerial orders, bylaws and investment policy, and invest in diversified assets with prudence. MHLW interpretational guidelines are applied to the conduct of employers with contract-type DBCPs to the extent possible.
- If employers breach or neglect their duties, participants can claim an indemnity for losses caused by such breach or negligence. MHLW can issue orders and impose administrative sanction to employers.
- Other legal restrictions and rules applicable to contract-type DBCPs are the same as for fund-type DBCPs including (a) the range of investable asset, and (b) duty of loyalty and care required of financial contractors. In contract-type DBCPs, it is impossible to have a director specialized in investment management or to manage assets in-house.

2. 4. 4 TQPPs

- With regard to TQPPs, there is no legal statute specifically applied to the investment activities of employers, their staff or financial contractors. There is no explicit rule stipulating the employer's fiduciary duty of loyalty to participants. For example, employers are not required to formulate investment policy. Accordingly, general labor laws and the Civil Code are applied to employer activities, putting employers under the duty of care.
- Financial contractors such as trust banks, insurance companies and investment managers will be regulated by laws and regulations focusing not only on their pension activities but also on their financial activities in general. For example, investment management firms are required to perform their business solely for the benefit of clients by Financial Product Transaction Act. The Financial Services Agency enforces these laws and rules.

2. 5. Membership Rights—Qualification, Vesting, Portability, Information (ref. Core Principle 5)

2. 5. 1 Membership

- In EPFs, DBCPs, TQPPs and DC plans, discrimination in admitting any employee for participation is prohibited in principle. But in EPFs, DBCPs or DC plans, participation is limited to those participating in the public pension as employees, or No. 2 insured. Part-time workers categorized as self-employed (No. 1 insured) or as non-working spouses of employed persons (No. 3 insured) do not qualify for participation. Fixed-term employees and temporary basis workers cannot join TQPPs.
- Furthermore, EPFs can impose participation requirements based on minimum age and/or minimum years of employment. If EPF employers want to restrict participation by age, the law requires that employees age 25 and over be admitted for participation. If they restrict membership based on years of service, the maximum waiting period after employment permitted by law is five years. If employers use both requirements, the sum of minimum age and working years cannot be larger than 28.
- For DBCPs, participation can be limited by job classification, age, years of service and/or the employee's own will. The law requires that the minimum age for participation not exceed 28, and the maximum age is not below 50. The required years of service cannot exceed five years. If participation is restricted by job classification or employee's intention, non-participant employees must be compensated for the lost benefits appropriately and equally as participants.

- In TQPPs, participation can be restricted based on age and/or years of service, as long as that condition is reasonable.
- DC plans also set a certain qualification in their bylaws to limit participation. Four types qualification are the same as in the case of DBCPs. However, a minimum age restriction is not allowed, and the maximum age restriction must be no less than age 50.
- In sum, laws allow employers to use retirement benefits as a tool and incentive in human resource management to some extent.

2. 5. 2 Vesting

- After admitting participants, employers may want to delay vesting and forfeit beneficiary rights if an employee leaves the job with a short tenure. With this rule, employers can promote longer tenures. Or, if benefits are not forfeited, but instead increase steeply and disproportionately with respect to tenure, those leaving after a short tenure are at a disadvantage. In this case, the benefit curve is said to be (overly) back-loaded.
- In case of severance benefits, there is no restriction on minimum tenure for vesting or back-loading of the benefit curve. Back-loading of the benefit curve is not restricted in EPFs, DBCPs or TQPPs. On the other hand, EPFs and DBCPs must pay an annuity if an employee leaves after 15 years of service, and must pay a lump-sum severance benefit to those leaving after three years of service.[22]
- There are two exceptions to the principle that vested benefits must be paid in full. First, the benefit amount can be altered depending on the reason of job termination. Especially when employees are young, the benefit amount in case of voluntary termination is much lower than in case of involuntary termination. Second, the benefit amount can be reduced or taken away as a disciplinary penalty if employees are dismissed, or if they change to another employer in the same business.
- From the above, we can see that employers try to use retirement benefits as a tool to influence employee behavior at the workplace.
- In case of DC plans, employees can be forced to return all or part of the assets accumulated in their individual accounts if they leave the job with less than three years of service. Otherwise, assets are paid to employees irrespective of the reason for job termination.

2. 5. 3 Portability

- Once vested, unless benefits are paid by the former employer in the form of an annuity, the lump-sum payment or benefit credits[23] of defined benefit plans can be transferred to the new employer or to the PFA. Assets from either the former employer's EPFs and DBCPs or DC can also be transferred to a DC at the new employer or to the National Pension Fund Association (NPFA).
- Lump-sum payments from EPFs and DBCPs can be transferred to the PFA. The PFA manages the fund and pays an annuity after retirement. DCs and the NPFA can also accept funds from EPFs and DBCPs. Benefit rights arising from a past service record in an EPF or DBCP can be transferred to and assumed by another EPF or DBCP at the new employer, if the latter EPF or DBCP agrees to that transfer.

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[22] Because of concern about tax evasion, TQPPs are restricted from paying benefits to those with a short tenure. If benefits are unpaid, short-tenured workers receive a severance beenfits, since TQPPs play the role of funding tool for severance benefits.

[23] Benefit credit refers to the right to receive a pension based on the tenure and salary record at the previous employer. Usually, the amount of benefit is calculated based on the tenure and salary.

- Upon leaving a DC, assets accumulated in each employer's account can be transferred to another DC at the new employer or to individual DC plans at the NPFA[24].
- These arrangements, which have the effect of promoting portability, do not apply to severance benefits or TQPPs.

2. 5. 4 Disclosure of Information

- EPFs, fund-type DBCPs and employers with contract-type DBCPs must make their best efforts to disseminate information on the content of plan bylaws and results of plan operations in a way that is clearly understood by current and former participants. The required information is as follows:
  (a) benefit design and normal amount by benefit type,
  (b) number of participants and beneficiaries of each type of benefit,
  (c) breakdown of benefit amount by type and general payment situation,
  (d) amount, timing and general situation of employer's contribution to pension funds,
  (e) balance of plan assets as well as comparison with benefit liabilities and minimum funding requirement, and general situation of plan assets,
  (f) investment gains and losses, asset composition, and general situation of investment, and outline of investment policy.[25]
  (g) other important information regarding the pension fund operation.
- For the purpose of information dissemination, EPFs, fund-type DBCPs and employers with contract-type DBCPs must utilize one of the following media: (a) posting at a visible place in operational offices, (b) delivery of document to each participant, (c) placing a computer terminal at each operational office so that participants can always access and confirm their personal records, or (d) other media that can disseminate the information with certainty.
- There is no such explicit legal requirement of information disclosure in case of TQPPs.

2. 5. 5 Employer's and contractor's obligation in DC plans (excluding those mentioned in foregoing sections)

- In case of DC plans, employers as well as financial contractors owe fiduciary responsibility—duty of loyalty to participants and duty of care. For example, employers must select DC plan administrators and trustees with care and loyalty. Employers are prohibited from concluding contracts with financial administrators or trustees out of the intent to promote their own interests or those of third parties. They are also prohibited from being engaged in activities that harm the protection of participants, such as recommending investment in specific products or the selection of specific plan administrators.
- Record-keeping plan administrators must advise each participant of the amount of accumulated assets in his/her account, financial product composition, transaction results, and contribution amount at least once a year.
- With regard to investment alternatives, employers must provide at least three types of products with different risk-return profiles, at least one of which must have its principal value protected. Employers must provide participants (employees) with opportunities to transfer their wealth from one product to the other at least once every three months.
- Employers are also under obligation to notify plan participants (employees) of the content of bylaws and the names of plan administrators. In addition, they are required to exert their best

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[24] If the contribution period is no longer than 3 years or the account has no more that 500,000 yen, a participant can choose to receive cash instead of transferring assets to another DC account.

[25] Small EPFs and fund-type DBCPs with fewer than 300 participants and the amount of asset less than 300 million yen are not obliged to disclose this item.

efforts to disseminate information and educate employees in the areas of investment and finance such as risk-return, diversification, and long term investment, and ultimately to improve their financial literacy.

- Selecting specific investment products in a plan is the responsibility of DC plan administrators. They must disclose and explain the rationale for selection, and disseminate information on important product attributes such as (a) expected yield and return, (b) performance record in the last 10 years, (c) fees and commissions, (d) the effect of protection scheme including deposit insurance, (e) the possibility of loss in principal and negative return. If plan administrators neglect those obligations, participants can claim administrators to indemnify losses caused by such breach of duty.

2. 6. Supervision (ref. Core Principle 6)

2. 6. 1 Severance benefits

- The severance benefit is part of the employer's operation and is bound by general labor laws. The employer's obligation and employees' rights depend on these laws and their interpretation by courts.

2. 6. 2 EPFs and fund-type DBCPs

- MHLW supervises EPFs and fund-type DBCPs. EPFs and fund-type DBCPs must file: (a) an annual business report, and (b) financial statements consisting of the balance sheet and income statement to MHLW within four months after the end of the fiscal year. Upon submission, directors must attach the auditors' opinion to the documents and obtain the approval of representatives. Any active or former plan member has the right to request access to the filed information. Also, a certified pension actuary must review and confirm that the documents submitted to MHLW are based on appropriate actuarial principles, and affix a seal of certification.
- Either on their own initiative or at the request of participants' representatives, auditors must inspect activities of directors including the filing of the foregoing documents in accordance with the auditing rule which they formulate under the guideline of MHLW. Auditors can submit their opinion on the management of the pension fund to the EPF and fund-type DBCPchairperson, board of directors, representatives' meetings, and MHLW.
- EPFs and fund-type DBCPs must abide by the occasional decrees of MHLW. MHLW is authorized to order EPFs and fund-type DBCPs to report on their financial situation, to interrogate the fund's staff, and to conduct on-site inspection of fund offices.[26] If MHLW discovers any illegal activities at pension funds, they can issue orders for improvement of business, change in by-laws, dismissal of directors, and/or termination of the plan.

2. 6. 3 Contract-type DBCPs

- MHLW supervises employers. Employers must file (a) an annual business report, and (b) financial statements consisting of balance sheet and income statement to the offices of MHLW within four months after the end of fiscal year. There is no need to attach the auditor's opinion in this case. A certified pension actuary must scrutinize and confirm that documents submitted to MHLW are based on appropriate actuarial principles, and affix a seal of certification.
- Employers with contract-type DBCPs are under the same regulatory and supervisory authority as EPFs and fund-type DBCPs. They also owe the same explanatory, reporting and disclosure obligation to participants.

2. 6. 4 TQPPs

[26] EPFs must file a quarterly report, while DBCPs must submit an annual report to MHLW.

- The National Tax Agency has the authority to supervise TQPPs but the extent of their regulation is relatively limited and supervision is not very rigid. Obligations of the employer arise from the contract with the financial contractor, which is registered t the National Tax Agency at the time of establishment as we mentioned in 2.1.

2. 6. 5 DCs

- MHLW supervises employers. Employers must file (a) an annual business report, and (b) financial accounts to the offices of MHLW after the end of each fiscal year. MHLW has the authority to order employers to report on plan conditions, interrogate pension staff, and make on-site inspections. If MHLW discovers any illegal activities of DC plans, they can issue an order for improvement of operation, and/or invalidate the plan bylaws.
- MHLW can also supervise plan administrators. They can issue an order to file reports. MHLW can make on-site inspections, order the improvement of operations, and suspend the registration of a plan administrator.
- There are no qualification requirements for executives or managers responsible for DC plan management. Most of the management staff are employees of the sponsoring employer.
- Employers and financial contractors in breach of the legal duties will be put under administrative sanction and penalty, and will be subject to employer claims to indemnify losses caused by such breach of duty.

2. 7. Pension Fund Governance

In addition to the Core Principles, OECD also released the Guidelines on Pension Fund Governance in April 2005. We understand that OECD plans to integrate the guidelines with the Core Principles in the near future. Considering this plan, this subsection discusses Japanese pension laws and regulations relating to the governance of pension funds. Since governance relates to several clauses of the Core Principles, part of the discussion reiterates foregoing sections.

2. 7. 1 Severance Benefits

- Severance benefits are part of the employer's operation. Thus the employer manages and administers this benefit as part of its human resource operation, usually without the usage of outside experts or outsourcing of responsibilities. No special scheme or entity is required.
- No qualification is required for the management of severance benefits.
- There are no special laws, rules or regulations that govern severance benefits. Employers are bound by general labor laws and regulations and working rules.

2. 7. 2 EPFs and fund-type DBCPs

- EPFs and fund-type DBCPs are independent and separate entities from the employer. Thus both plans have their own board of directors and managing directors and staff, and conclude a contract with a financial services contractor.
- EPFs and fund-type DBCPs have the same governance structure. The employer and employees both elect the same number of representatives, who in turn nominate the same number of members to the board. One board member from the employer's side serves as chairperson and nominates managing directors. Representatives of the employer and employees each select one of the two auditors.
- Plan management and administration activities are undertaken by the board of directors, managing directors of the plan, and outside financial contractors. Directors can outsource some of their assignment and use outside experts in the manner pursuant to bylaws. They are bound by plan bylaws, resolutions of representative meetings, and contracts, as well as by legal statues

specially applied to EPFs and fund-type DBCPs. All of these parties are considered to owe fiduciary responsibility consisting of duty of loyalty and care, even if they outsource a part of their assignments.

- To ensure the duty of loyalty to plan participants, laws prohibit directors from engaging in conducts with the intent to promote their own interests and/or the interests of third parties. Ministerial guidelines list specific conducts which would be interpreted to breach that prohibition if due consideration of appropriateness to the duty of loyalty is lacking, such as: (a) selecting outside contractors who have a good relationship with the employer, (b) instructing the investment manager to invest in securities issued by the employer or by enterprises affiliated with the employer, and (c) instructing the investment manager to transact securities with the employer or its affiliates.
- Directors who breach the foregoing duties must indemnify jointly and severally the losses caused by such conduct to EPFs and DBCPs. These directors can be replaced by means of a resolution of the representatives' meeting. Administrative sanctions can also be imposed on EPFs and DBCPs by MHLW.
- An MHLW ministerial decree prescribes that these funds specifically appoint a managing director to perform the task of investment management. An interpretational guideline stipulates that the managing director should be a person with knowledge of the pension plan's financial status and the capacity to perform their duties properly. The guideline also encourages these directors to train themselves in the field of investment management. Otherwise, there is no qualification requirement for directors.
- Two auditors representing labor and management respectively also scrutinize the business results of EPFs and fund-type DBCPs.
- There are also legal requirements for EPFs and fund-type DBCPs to report on their condition to the supervising MHLW, and to make information available to participants regarding the plan's operation.
- EPFs and fund-type DBCPs must abide by the occasional decrees of MHLW. MHLW is authorized to order EPFs and fund-type DBCPs to report on their financial situation, to interrogate the fund's staff, and to conduct on-site inspection of fund offices. If MHLW discovers any illegal activities at pension funds, they can issue orders for improvement of business, change in by-laws, dismissal of directors, and/or termination of the plan.

2. 7. 3 Contract-type DBCPs

- Contract-type DBCPs are not independent legal entities. There are no independent boards, auditors or representatives. Thus the employer manages the pension plan as part of its operation in cooperation with a financial contractor.
- Employers and financial contractors are bound by plan bylaws and legal statute specifically applicable to DBCPs. All of them are considered to owe fiduciary responsibility consisting of duty of loyalty and care.
- To ensure the duty of loyalty to plan participants, laws prohibit employers from engaging in conducts with the intent to promote their own interests and/or the interests of third parties. Ministerial guidelines list specific conducts which would be interpreted to breach that prohibition if due consideration of appropriateness to the duty of loyalty is lacking, such as: (a) selecting outside contractors who have a good relationship with the employer, (b) instructing the investment manager to invest in securities issued by the employer or by enterprises affiliated with the employer, and (c) instructing the investment manager to transact securities with the employer or its affiliates.
- Employers can outsource some of their assignment and make use of outside experts in the

manner pursuant to bylaws.

- Other than the employer, there is no specific governing body or persons who are responsible for pension plan management. There is no qualification requirement to be engaged in the management of pension plans.
- If employers breach or neglect their duties, participants can claim an indemnity for losses caused by such breach or negligence.
- Employers owe the obligation to periodically report to MHLW about their management condition. MHLW can issue orders and impose administrative sanction to employers. Employers also owe the same explanatory, reporting and disclosure obligation to participants as in the case of fund-type DBCPs.

2. 7. 4 TQPPs

- TQPPs are part of the employer's operation, and are managed in cooperation with financial contractors. There are no independent boards, directors or auditors.
- There is no legal statute specifically applicable to the investment activities of employers, their staff or financial contractors, including rules stipulating the employer's fiduciary duty of loyalty to participants. Only general labor laws and the Civil Code are applied to the employer's activities, putting employers under the duty of care.
- There are no laws or regulations specifically prohibiting employers with TQPPs from performing specific conducts that cause a conflict of interest.
- There is no qualification requirement for engaging in the management of these pension plans.
- Financial contractors such as banks, insurance companies and investment managers are regulated by laws and regulations that pertain not only to their pension activities but also to their financial activities in general. For example, under the Financial Instruments and Exchange Law, investment managers are required to perform their business solely for the benefit of clients. The Financial Services Agency enforces these laws and rules.
- The National Tax Agency has the authority to supervise TQPPs, but the extent of their regulation is relatively limited, and their supervision is not very rigid. Obligations of the employer arise from the contract with the financial contractor.

2. 7. 5 DCs

- DC plans are part of the employer's operation and managed in cooperation with financial contractors such as DC plan administrators and DC plan trustees. DC plans themselves do not have any legal existence.
- Employers and financial contractors are bound by plan bylaws and legal statutes specifically applicable to DCs. Both entities are considered to owe fiduciary responsibility consisting of duty of loyalty and care.
- To prevent conflicts of interest, employers are prohibited from concluding contracts with plan administrators or trustees with the intent to promote their own interests or those of third parties. Employers are also prohibited from engaging in activities that harm the protection of participants, such as recommending investment in specific products or selection of specific plan administrators.
- Other than the employer, there is no specific governing body or persons who are responsible for pension plan and fund management. There is no qualification requirement for engaging in the management of DC plans.
- With regard to disclosure, employers are required to exert their best efforts to disseminate information and educate employees regarding investment and finance topics such as risk-return tradeoff, diversification and long term investment, and ultimately to improve their financial

literacy.

- After the end of each fiscal year, employers must file (a) an annual business report, and (b) financial statements to the offices of MHLW. MHLW has the authority to order employers to report on plan conditions, interrogate pension staff, and make on-site inspections. If MHLW discovers any illegal activities of DC plans, they can issue an order for improvement of operation, and/or invalidate the plan bylaws.
- With regard to recordkeeping, plan administrators must inform each participant of the accumulated account assets, financial product composition, transaction results, and contribution amount at least once a year.
- With regard to investment, plan administrators must select specific investment products with prudence and expertise. They also must disclose and explain the rationale for selection, and inform participants regarding important investment product characteristics. If plan administrators neglect these obligations, participants can file a claim against administrators to indemnify losses caused by the breach of duty.

SECTION 3. Comparisons with Recommendation on Core Principles

In this section, we compare the private pension regulations explained above with OECD Recommendation on Core Principles on Pension Plan Regulation. We also explain both the commonalities and differences between Japanese regulations and the six Core Principles as well as Guidelines on Pension Fund Governance.

3. 1. Conditions for effective regulation and supervision

3. 1. 1 Commonalities

Core Principle 1 says that pension plans must be subject to a legal framework that covers several important aspects such as the protection of member rights. In this respect, all tax-qualified plans in Japan—EPFs, DBCPs, DCs, and TQPPs—are regulated by specific legal provisions. In particular, the regulation of EPFs and DBCPs, which is implemented by MHLW, covers various areas such as contributions and benefits, pension funding rules, membership and vesting, and asset management.

In addition, Core Principle 1 points out that the diversified investment of retirement savings requires the existence of well-functioning capital markets. Japan's capital markets are among the most developed in the world, with very few market regulations to impede pension fund investment activities both domestically and overseas. Thus it is difficult to point out significant discrepancies with Core Principle 1.

3. 1. 2 Differences

Severance benefits are regulated not by specific legal statutes, but by general labor laws.

TQPP is regulated by tax laws and the National Tax Agency of the Ministry of Finance. However, this regulation is not as specific or strict as MHLW regulation of EPFs and TQPPs, especially in the area of funding and investment rules. For example, a ministerial order of the National Tax Agency stipulates only the maximum amortization amount of a funding shortfall but no minimum ratio or amount per year. In addition, there are no explicit legal statutes to require employers and pension funds to respect the duty of care or duty of loyalty.

3. 2. Establishment of pension plans, pension funds, and pension fund management companies

Core Principle 2 recommends that an institutional and functional system of adequate legal, accounting, technical, financial and managerial criteria should apply to pension funds and plans. It also says that pension funds must be legally separated from employers.

3. 2. 1 Commonalities

Legal provisions exist for the establishment process of EPFs, DBCPs, TQPPs and DCs. Also, EPFs, DBCPs, and DCs are required to formulate bylaws which contain items related to organizational management, calculation and payment of contribution and benefit, and content of contracts with outside financial contractors. Upon establishment, bylaws must be authorized or approved by MHLW. In case of EPFs and fund-type DBCPs, laws also stipulate the management and governance scheme such as the powers of representative meeting, board of directors, and auditors, and their nomination. Assets of all pension funds are separated from employers under a trust or insurance scheme.

3. 2. 2 Differences

First, the management of contract-type DBCPs and TQPPs are part of employer operation and there is no independent governing body. Managers in the employer's organization are assigned to manage pension funds.

Secondly, in contract-type DBCPs employers owe fiduciary duty of loyalty to participants. However, employers owe fiduciary duty to company stockholders as well. By wearing two hats, managers of the employer may face potential conflicts of interest between plan members and employer's stockholders. In case of TQPPs, the situation may be worse because there are no explicit statutes stipulating the employers' duty of loyalty.

Third, severance benefit schemes have no independent managerial and administrative organization, separately accumulated assets, or governance rules.

3. 3. Pension plan liabilities, funding rules, winding up, and insurance

Core Principle 3 requires an adequate financial framework consisting of: (a) a proper funding rule including termination-basis funding, (b) encouragement of funding by tax and regulations, (c) appropriate calculation methods for asset and liability value as well as for funding, (d) proper winding-up mechanisms, and (e) insolvency insurance.

3. 3. 1 Commonalities

All pension funds are funded outside of the employer, and laws stipulate funding rules which require defined benefit plans to check their funding status at least once every five years. Ministerial orders prescribe rules on contribution payments to compensate for funding shortfalls of the pension liability. Rules also set the actuarial assumptions used in the funding rule and the valuation method for assets and liabilities. There is not very much room for management discretion.

In addition, except for TQPPs, the funding level of defined benefit plans is continuously scrutinized from two aspects—going-concern basis and termination basis.

3. 3. 2 Differences

First, although the funding requirement is applied to each type of defined benefit plan, the level of benefits can be reduced in case of the employer's financial distress provided that labor and management agree on the reduction. In case of plan termination, while full funding of the pension liability is required, such full funding can be attained by reducing benefits instead of increasing contributions.

Secondly, upon the employer's bankruptcy, except for the case of EPFs, claims of unpaid contribution or unfunded pension liability do not have any prioritized status, and are treated equally with other general creditor rights.[27]

Third, guarantee schemes exist for EPFs and severance benefits. Since both the guaranteed benefit level and conditions for the guarantee are limited, the function of these schemes is weaker

[27] As we discussed in Section 1, in most cases, as a substitute for claims for unfunded pension benefits, employees can assert claims for severance benefits, which have priority over general creditor rights.

than their counterparts in several other OECD countries.

Fourth, while funding rules are generally detailed and strict, there is room for delaying the recovery of funding. For example, the longest period for amortizing unfunded liabilities is 20 years for EPFs and DBCPs on a going-concern basis. Also, under the termination-basis funding rule, EPFs and DBCPs are required to reach only 90% instead of 100% of the termination basis liability value within 10 years.

Fifth, a special corporate tax imposed on pension fund assets other than EPFs, and which collects 1.173% of asset value every year, may work as an impediment to faster funding.

Finally, severance benefits, which are provided by 69.7% of all employers, are based on an unfunded book reserve scheme.

3. 4. Asset management

Core Principle 4 recommends pension investment regulation to encourage ALM, institutional/functional approach, diversification, and maturity and currency hedging as well as modern, effective risk management. Core Principle 4 also stipulates that Self-investment should be limited and investment abroad should be permitted.

3. 4. 1 Commonalities

Directors of EPFs and fund-type DBCPs engaging in asset management are under fiduciary obligation consisting of duty of care and duty of loyalty to pension funds. Employers with contract-type DBCPs owe fiduciary obligation consisting of duty of care and duty of loyalty to plan participants.

They are required to discharge their duties with care and skill as a prudent person. As part of the duty of care, laws explicitly require diversification of investment as well as formulation of a basic investment policy. They are also under obligation to make efforts to formulate an asset allocation policy and to employ a person with expertise in that field.

As part of the duty of loyalty, directors of EPFs and fund-type DBCPs, and employers with contract-type DBCPs are prohibited from investment activities causing conflicts of interest. Activities which aim to promote their own interests or those of employers—including investment in the employers' own securities—are prohibited.

On the other hand, as long as their investment activities are considered to be prudent, there is no quantitative restriction on investment in any category of assets including overseas investment.

3. 4. 2 Differences

First, there are no explicit investment regulations for TQPPs. Only the general Civil Code, and regulation on financial contractors are applied to their investment activities.

Second, the formulation of strategic asset allocation with due consideration to long-term asset and liability management is not an absolute legal requirement for EPFs and DBCPs. They are only required to make efforts to do so.

Third, the managing director responsible for investment activities in EPFs and fund-type DBCPs must have knowledge about pension plan financial conditions and the capacity to perform their duties properly. It is difficult in reality, however, to have a person with expertise in the investment field especially for smaller pension funds. In these pension funds, the capacity of managing directors engaged in investment may not reach the point of "prudent expert."

3. 5. Rights of participants and beneficiaries and adequacy of benefits

Core Principle 5 stipulates various aspects of plan participants' rights. It recommends: (a) equal treatment among employees and avoidance of discrimination, (b) protection of accrued benefits and proper vesting, (c) pension portability, (d) proper assessment of benefit adequacy, (e) disclosure and dissemination of information, and (f) education and adequate rights for members in

defined contribution plans.

3. 5. 1 Commonalities

In all pension plans, in principle all employees must be treated equally. In EPFs and DBCPs, the maximum waiting periods for membership and vesting are restricted.

As far as portability is concerned, lump-sum payments from EPFs and DBCPs can be transferred to the PFA. DCs and NPFA can also accept funds from EPFs, DBCPs and other DCs. Benefit creditss and past contribution records in one EPF or DBCP can be transferred to and assumed by another EPF or DBCP at the new employer.

Assets accumulated in each employee's DC account can be transferred to another DC at the new employer or to individual DC plans at NPFA.

Laws require directors at EPFs and fund-type DBCPs and employers with contract-type DBCPs to disseminate detailed information about benefits, contributions, plan assets and liabilities, and investment activities by one of the designated media.

For DC plans, employers are obliged to disseminate information, as well as to make efforts to provide financial education to plan participants and improve their financial literacy. Laws require employers and plan administrators, who are usually responsible for the selection of investment vehicles, to prepare at least three different investment alternatives, and to explain the reasons for selection and attributes of each product to plan participants.

3. 5. 2 Differences

First, restricting participation in pension funds by age, tenure, and/or job classification is permitted. Even among employees working for the same employer, some are eligible for participation and others are not.

Second, accrued benefits can be forfeited in case of disciplinary dismissal or change of employment to another company in the same business. The Core Principle stipulates that benefits can be forfeited in limited cases of dismissal resulting from acts of gross malfeasance that are clearly defined. Reasons for forfeiture are not clearly defined in advance in Japan. Benefit amounts can also be increased steeply with age and/or tenure in order to retain workers longer.

Third, lump-sum payments of severance benefit plans or TQPPs are not portable. The funds received cannot be transferred to any other tax-qualified pension plans.

Fourth, legal statutes give no consideration to the level of adequate benefits or desirable form of benefit payment except in the case of EPFs[28]. A termless annuity is not common in pension plans other than EPFs. Benefit indexation to prices is even more unusual. Consideration of needs in life after retirement is not prioritized.

Fifth, disclosure and dissemination of plan and individual benefit information is not adequate in severance benefits and TQPPs.

3. 6. Supervision

Core principle 6 emphasizes the necessity of supervision focusing on compliance, financial control, actuarial examination and supervision of managers. For that purpose, an appropriate supervisory body with adequate funding, staff and regulatory power should be established. That body must conduct off-site and on-site inspection if necessary.

3. 6. 1 Commonalities

The supervisory body for EPFs, DBCPs and DCs is MHLW. Laws empower MHLW with the authority to make pension funds submit periodic and temporary reports, interrogate plan managers, and implement on-site inspections.

MHLW can impose an administrative penalty for negligence of legal requirements or

[28] The target level of benefit is 3.23 times the substitution component, and provision of the termless annuity is mandatory in EPFs.

misrepresentation in submitted reports. MHLW can also order the improvement of operations, amendment of bylaws, and dismissal and change of directors. MHLW supervises plan administrators of DC plans as well.

3. 6. 2 Differences

For TQPPs, the supervisory authority of the National Tax Agency is not well-defined. Appropriateness of management largely depends on the self-assessment of financial contractors. The National Tax Agency rarely implements off-site or on-site inspections.

Also, in case of severance benefits, there is no agency to supervise and execute on-site inspection of plan management.

3. 7. Governance

OECD guidelines for pension governance stipulate the desirable governance structure with regard to identification of responsibilities and governing body, accountability and minimum suitability. Guidelines also prescribe governance mechanisms such as disclosure and reporting. Here we compare these guidelines with regulations relating to pension governance in Japan.

3. 7. 1 Commonalities

EPFs and fund-type DBCPs are independent entities from the employer, and have a clearly identified governing body—the board of directors. The responsibilities of directors are explicitly defined by laws, regulations and bylaws. These include the duty of care and loyalty, and the obligations of reporting to MHLW and disclosure to participants. Laws also prohibit specific conducts that lead to conflicts of interest.

Directors of EPFs and fund-type DBCPs must indemnify losses caused by the breach of their duties. Although not very specifically, laws and ministerial decrees stipulate the qualification requirement for managing director specialized in asset management.

With regard to contract-type DBCPs, employers owe the duty of loyalty and duty of care. In order to prevent conflicts of interests, laws prohibit employers from engaging in conducts that may lead to conflicts of interest. Other legal responsibilities of employers include duty of care and loyalty, and the obligation of reporting to MHLW and disclosure to participants.

For DCs, laws and regulations prohibit conflicts of interest, and stipulate these same duty loyalty and care for employers who are regarded as the governing body. Laws also define their responsibilities of reporting to MHLW and disclosure to employees.

3. 7. 2 Differences

Contract-type DBCPs, TQPPs and DCs are part of the employer's operation. They have no specific governing body of persons or organizations responsible for plan management. Therefore, there is no qualification requirement for plan management.

For severance benefits and TQPPs, there are no explicit legal stipulations regarding the employer's duty of care and loyalty, prevention of conflict of interest, nor the obligations of reporting to a supervising authority and disclosure to plan participants.

SECTION 4. Recommendations

Based on the foregoing observations, the author extends the following recommendations for pension regulation in Japan and for the OECD Core Principles.

4. 1. Recommendation for Japan

4. 1. 1 Protection of benefit rights in TQPPs and severance benefits

Compared with EPFs and DBCPs, the regulation of TQPPs and severance benefits is inadequate and incomplete. For example, the duty of care and loyalty is not explicitly required in the asset management operation of TQPPs.

Among other things, lump-sum benefits received from TQPPs and severance benefits cannot be transferred to any other tax-qualified pension plans, PFA or NPFA. Portability is limited among

these plans. The author recommends making it possible to transfer such lump-sum benefits at least to PFA. As seen in Section 1, TQPPs must be terminated and converted into other benefit schemes by the year 2012. When terminated, the assets of TQPPs are divided among current beneficiaries and participants and the employer. Making the distribution to employees portable to other pension plans will be valuable for employees who receive the lump-sum distribution due to plan termination rather than job separation.

As a task for the longer time horizon, it is very important to secure the payment of severance benefits because they are unfunded and cannot be relied upon at the time of employer bankruptcy. It might be advisable to introduce a mandatory payment insurance scheme supported by the government, especially for small-enterprise employees. Current public guarantee scheme which we explained in Section 2.3.1., is very small in terms of coverage as well as the guaranteed amount. If employers with a funded pension scheme are exempt from the obligation to participate in the insurance scheme, it would work as an incentive to introduce a funded pension scheme.[29]

4. 1. 2 Consolidation of smaller plans and economies of scale

Not only among TQPPs but among smaller EPFs and DBCPs as well, asset management practices are not very sophisticated. This is partly because smaller plans and employers lack qualified internal human resources, and partly because smaller defined benefit plans cannot afford to pay decent salaries to retain experts in pension fund investment.

In order to solve this problem, MHLW should encourage pension funds, and especially smaller multi-employer plans, to consolidate and take advantage of economies of scale. If single-employer plans have difficulty consolidating and remain small, MHLW should encourage financial contractors to provide well-balanced investment funds with various risk profiles to defined benefit pension plans.

4. 1. 3 Tax revision to promote funding

Core Principle 3 suggests that the tax system should be designed to promote funding of pension plans. However, in Japan, the special corporate tax that is levied on pension assets may function as a disincentive for funding by employers, since in effect earnings on pension assets are taxed in the same way as if they were interest earned on wages distributed to employees.[30] Earnings on accumulated assets should be made tax exempt by abolishing the special corporate tax.[31] In view of the expected reduction of the public pension EPI benefit level,[32] a tax system that

[29] As in Stewart (2007), in order for this benefit guarantee scheme to function properly, the following conditions must be satisfied:
--limited benefit coverage
--risk-based premium setting
--accurate and consistent funding rule
-- prudent asset-liability management
-- adequate powers

[30] This is because contributions are tax-deductible for employers but technically cannot be taxed yet as employee income. Taxes are deferred until benefits are distributed as income to retired employees. Since the purpose of the special corporate tax is to compensate for tax losses brought about by this deferred tax treatment, the tax is levied on earnings on the accumulated contribution. The tax rate of 1.173% is calculated by multiplying 17% (average marginal individual income tax rate) by 7% (interest rate per annum).

[31] Considering the very low level of market interest rates, the special corporate tax has been suspended from fiscal 1999. The current suspension is effective until the end of fiscal 2007 (March 2008), after which the continuance of the suspension will be discussed.

[32] As a result of the 2004 reform, the expected income replacement rate for a married couple with one earner is assumed to decline from 59.3% in 2004 to 50.2% in 2023.

promotes the introduction and maintenance of pension plans and faster funding of pension plans is desirable.

4. 1. 4 Extension of coverage

Currently, workers can be excluded from pension plan participation based on job classification. Part-time workers and fixed-term workers are usually not covered by any retirement benefit plan. The share of those non-regular workers among whole private sector workers has risen from 23% to 34% in the last decade.

However, since tax-qualified pension plans receive a subsidy from all tax payers and play the role of supplementing the public pension, pension coverage should be extended to those workers.

4. 2. Recommendation to OECD

4. 2. 1 Acceptance of flexible benefit protection

As seen in Section 2. 3., defined benefit plans in Japan can reduce the accrued benefits if several conditions are satisfied such as financial distress of the employer and agreement by labor and management. This is not permitted in the U.S. and other countries, where benefit rights accruing from past service are fixed, established and non-forfeitable.

This idea of a "hard" benefit protection brings about a serious financial risk to employers. In DB plans, employers face an interest rate risk, mortality risk and sometimes an inflation risk. We have witnessed the freezing and termination of defined benefit plans in the U.S. and U.K. amid the increasing volatility of contributions, pension expenses, and funding shortfalls.

If, in case of employer's financial distress, accrued benefits can be reduced, the employers facing a funding shortfall at the time of business hardship can alleviate their financial burden. In the long run, this will decrease the rate of plan freezing and termination. In reality, this feature allowed Japan's defined benefit plans to maintain primacy as a pension scheme in spite of the stock market decline and economic turmoil from the 1990s to early 2000s.

We are not in a position to discuss the superiority of defined benefit plans against defined contribution plans, which frequently replace frozen or terminated defined benefits plans. However, it is more desirable socially as well as for employees to maintain defined benefit plans rather than to terminate them without providing a substitute pension plan.

From this perspective, permitting accrued benefit reduction for plan sponsors in financial difficulty makes it possible for the employer to share a portion of the ex-post financial risk with employees and maintain DB plans. In other words, there are some cases when relaxing the concept of accrued benefits and taking a flexible, softer approach to protect benefit rights can lead to the welfare of employees by sustaining defined benefit plans. In recommending the Core Principles, the OECD might well take into consideration this idea of a softer regulatory framework.

In the same vein, OECD might well take into consideration that hybrid plans such as cash balance plans[33] in the U.S. and collective DC plans[34] in the Netherlands can be important options for benefit design because employers can share a portion of the ex-ante financial risk with employees.

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[33] In cash balance plans where the decline in interest rate is reflected in benefit amount, interest rate risk is shared between an employer and employees.

[34] In collective DC plans, investment risks are borne primarily by employees but employers usually try to contribute the amount necessary for the employee retirement security at the plan initial stage.

ANNEX

We cannot find any evidence of pension regulators referring to Core Principles in drafting or formulating legal statutes in the past. Actually, most legal statutes currently in force were enacted before the publication of the Core Principles in 2004. However, as we have seen, regulatory practices in Japan and the OECD principles have many common attributes, partly because both refer to the same precedents.[35]

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[35] Those responsible for pension regulation in the Ministry of Health Labor and Welfare know the existence of Core Principles. For the Core Principle to attract attention of them, OECD may want to have a close contact with the Ministry of Health Labor and Welfare as well as with the Ministry of Finance.

Tables and Charts

Table 1 Prevalence rate by type of benefits and employer size

(%)

Number of employees	Any form of retirement benefits					
		Severance Benefit	Any form of pension			
				EPF and DBCP	TQPP	DC
1，000 and over	97.1	78.6	86.4	44.9	60.8	2.4
300～999	95.7	70.4	74.0	29.2	61.1	0.7
100～299	89.5	70.2	58.4	26.5	43.3	1.2
30～99	84.7	69.2	38.9	18.6	22.9	0.7
Total	86.7	69.7	46.4	21.6	30.5	0.8

(at January 2003)

Source: Ministy of Health, Labor and Welfare

Table 2 Number of plans and active participants by plan types

(at March 31, of every year)

Type of plans	EPF	TQPP	DBCP	DCs	Total
Number of Plans					
2002	1,737	73,582	NA	70	75,389
2003	1,656	66,741	NA	361	68,758
2004	1,357	59,162	312	845	61,676
2005	838	52,761	987	1402	55,988
2006	687	45,090	1,432	1936	49,145
2007	658	38,885	1,941	2319	43,803
Number of Active Participants (million)					
2002	10.9	9.2	NA	0.1	20.2
2003	10.5	8.6	NA	0.3	19.4
2004	8.5	8.0	1.4	0.7	18.6
2005	6.2	6.5	3.1	1.3	17.2
2006	5.3	5.7	3.8	1.7	16.5
2007	5.2	5.1	4.3	2.2	16.8

Souce: Life Insurance Association of Japan,
Trust Companies Association of Japan

Table 3 Items to be included in bylaws of EPFs and DBCPs

	EPF	fund–type DBCPs	contract–type DBCPs	DCs
Name of plan	○	○	×	×
Location of plan offices	○	○	×	×
Name and address of employers	○	×	○	○
Name and addresses of offices covered by plan	×	○	○	○
Name and address of financial contractors	×	×	○	×
Representative and representative meetings	○	○	×	×
Board members	○	○	×	×
Qualification for plan participation	○	○	○	○
Standard wage	○	×	×	×
Amount, form and calculation of benefits	○	○	○	○
Contracts of asset management and custody	○	○	○	×
Contribution payment by employers and employees	○	○	○	○
Accounting period and financial reporting	○	○	○	×
Liquidation and termination	○	○	○	×
Outsourcing of services	○	○	○	×
Notification to participants	○	○	×	×
Other important managerial issues	○	×	×	×
Transfer and succession of benefit rights	×	○	○	×
Acceptance of lump–sum payments from other plans	×	○	○	×
Defrayment of expenditures	×	○	○	×
Welfare services	×	○	×	×
Employment by funds	×	○	×	×
Administrative service undertaken by employers	×	×	×	○
Name and address of outside administrators	×	×	×	○
Prsentation and direction of investment products	×	×	×	○
Calculation of amount returned to early leavers	×	×	×	○
Contracts of plan administration and custody	×	×	×	○
Contents of general investment education	×	×	×	○
Transfer of assets from other pensions and severance benefits	×	×	×	○

○= included
×＝not included

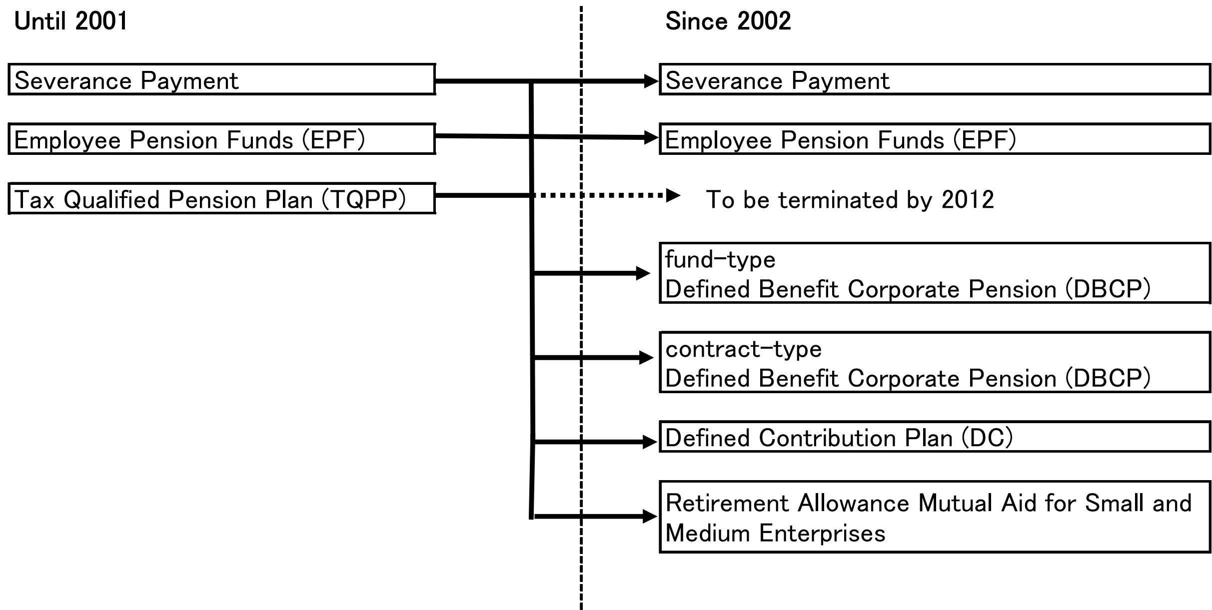
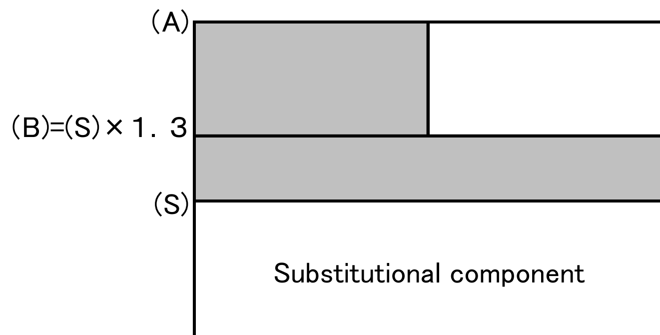


Chart 1 Overview of change in retirement benefit schemes



Maximum gurantee =(B)−(S)+50%×((A)−(B))

Chart 2 Maximum guarantee amount by EPF benefit insurance scheme