

Funded Pensions: The Japanese Experience and Its Lessons

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Japan at a Glance

● Population (in 2015)	126.9 million
● Population 65 +	33.4 million (26.3%)
● TFR (in 2015)	1.46
● GDP per capita (in 2014)	USD 38,644
● SS Pension Benefits (in 2014)	10.9% of GDP
● No. of SS Pension Enrollees	65.8 million (53%)
● No. of SS Pension Beneficiaries	39.9 million (31%)
● The Normal Pensionable Age	65

Japan: Some Characteristics (1)

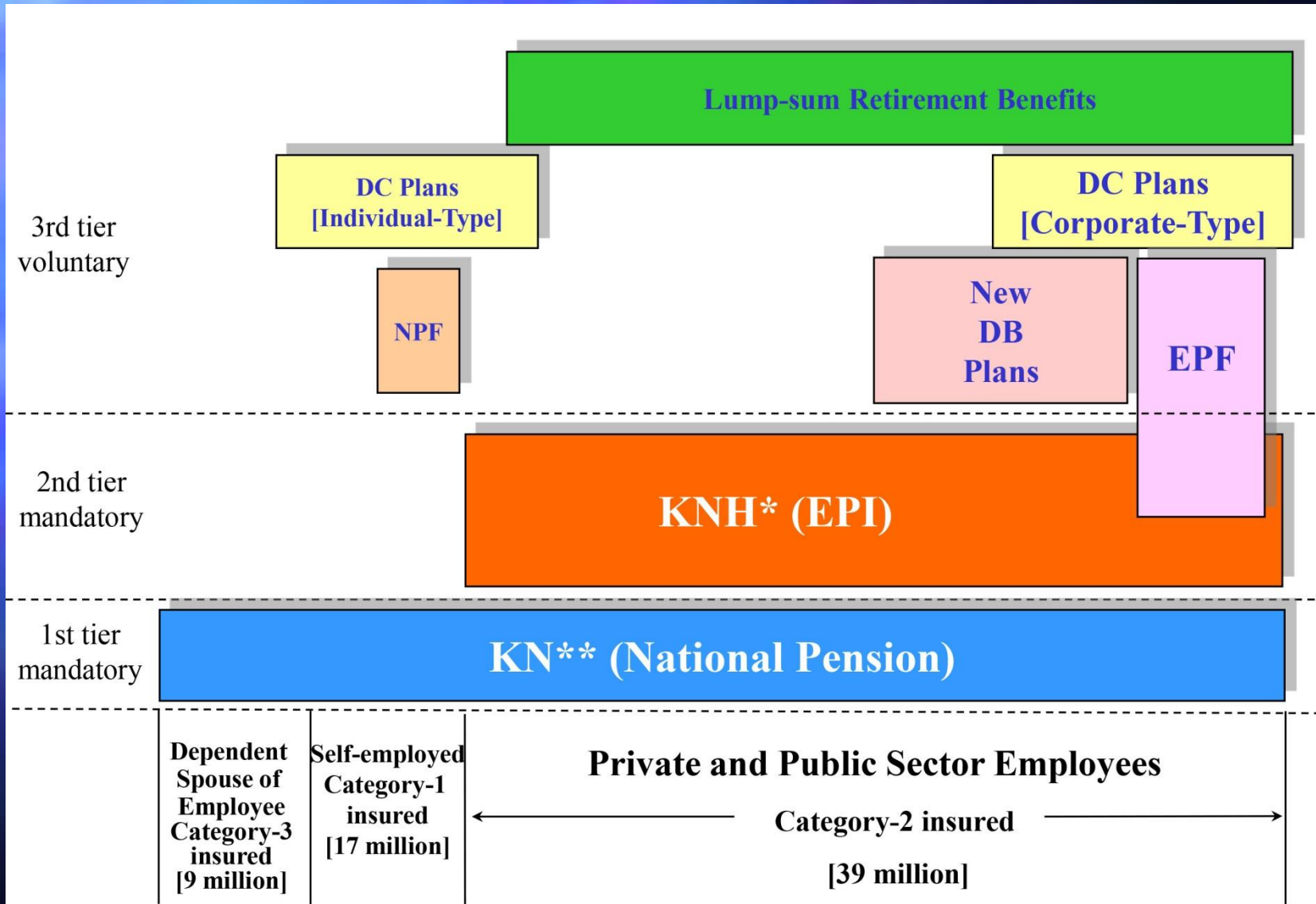
Pensions reflect the history, culture and philosophies of people living in respective countries.

- **The Yamato Japanese ethnic group comprises 98.5% of the total population, which makes people there quite homogeneous.**
- **Japan is largely mountainous and forested, with only 11.6% of its area arable land. The population density is virtually quite high.**
- **Natural disasters (earthquakes, typhoons, tsunamis, flooding, and volcanic eruptions) often hit Japan even today.**

Japan: Some Characteristics (2)

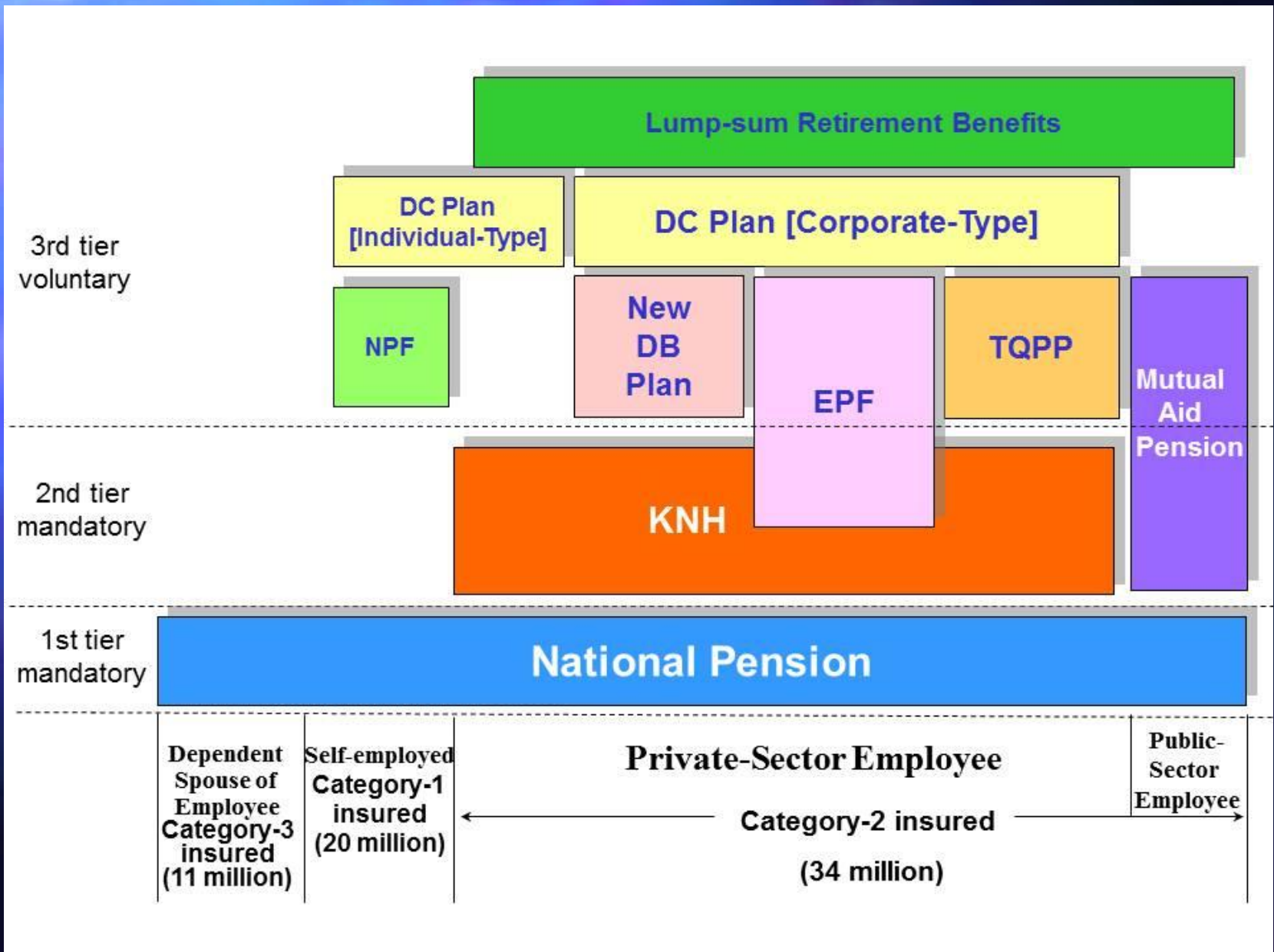
- Japanese have island-nation mentality and their way of thinking dates back from the one formed in an old rice-producing society.
- Japanese are ordinarily good at making materials lighter and more compact. They specially stick to comfort, convenience and details, searching for continuous improvement.
- Japanese people take it for granted that political power, wealth and authority should be held separately by different persons, and that any person should not monopolize all the three (or two).
- As far as pension policy-making in Japan is concerned, the most important person is Director-General of the pension bureau of the Ministry of Health, Labour and Welfare.

Retirement Benefits in Japan (as at September 2016)



* KNH: Kosei-Nenkin-Hoken (Employee Pension), ** KN: Kokumin-Nenkin

Retirement Benefits in Japan (as at March 2011)



The KNH: Its Start-up Phase (1)

- **Kosei Nenkin Hoken (KNH) has been the principal SS pension program for private sector employees (and for civil servants since October 2015). It was established during wartime days in 1942.**
- **Its initial design was based on a funded DB scheme that would build up reserves by not paying benefits in the early years.**
- **One of the main reasons for its set-up was to reduce the purchasing power of the Japanese people during World War II through mandatory reduction of contributions from their salary, thereby helping reduce the rate of inflation. The funded reserve was converted to partly finance the war expenses.**

The KNH: Its Start-up Phase (2)

- **The contribution rate (for employees and their employers combined) was initially set at 6.4% in 1942 and was hiked to 11% in 1944.**
- **Just after World War II, a hyperinflation occurred in Japan. Namely, the CPI increased 100 times between October 1945 and April 1949.**
- **The hyperinflation turned the KNH funded reserve into heaps of worthless paper, and the earned pension entitlements of employees became a nil, since they are a contract in nominal terms.**
- **Almost all Japanese were forced to manage to survive near a starvation level. The government reduced the KNH contribution rate to 3% in 1948.**

The KNH: Its Start-up Phase (3)

- **The KNH was rebuilt in 1954. In order to encourage employees to contribute, the government promised to pay a socially adequate level of pension benefits, regardless of the amount of contributions they have made. Thus, the KNH gradually shifted from a funded scheme to a pay-as-you-go one.**
- **Lesson 1: The funded pension program is very fragile under inflation (hyperinflation). Inflation does serious damages to the earned entitlements of funded pensions.**

The KNH: No Return to a Funded Scheme

- There have been some proponents, though quite minor in number, who advocate a switch of the KNH from a pay-as-you-go scheme to a funded one.**
- Its switch turns to be politically difficult, since it inevitably incurs a “double-burden” problem.**
- The only thing Japan can do in the future will be that the generous KNH benefits be reduced gradually, while participation in funded pensions on a private basis has to be more encouraged, instead.**

Non-mandatory Occupational and Individual Pensions

- **Lump-sum Retirement Benefit (DB)**
financed through a book-reserve system
- **Employee Pension Fund (EPF, DB)**
- **Tax Qualified Pension Plan (TQPP, DB)**
- **National Pension Fund (NPF, DB)**
- **New Defined Benefit Plan (DB)**
- **Defined Contribution Plan (DC)**

Latest Amounts of Funded Reserves

(JPY as at the end of March 2015)

EPF	28 trillion
New DB	58 trillion
DC	10 trillion
NPF	4 trillion
Sub Total	100 trillion
SS Pensions	200 trillion
Total	300 trillion

Lump-sum Retirement Benefit

The major non-mandatory pension provision in Japan has been a lump-sum retirement benefit. In 2013, 76% of employers provided this benefit. Especially for long-term regular employees it is a significant part of retirement income. For example, in 2011, the average private sector employee with service of 20 years or more received JPY25 million (USD250,000) from his or her employer. This amount was equivalent to 10-12 times the employee's *annual* pension benefit from the KNH.

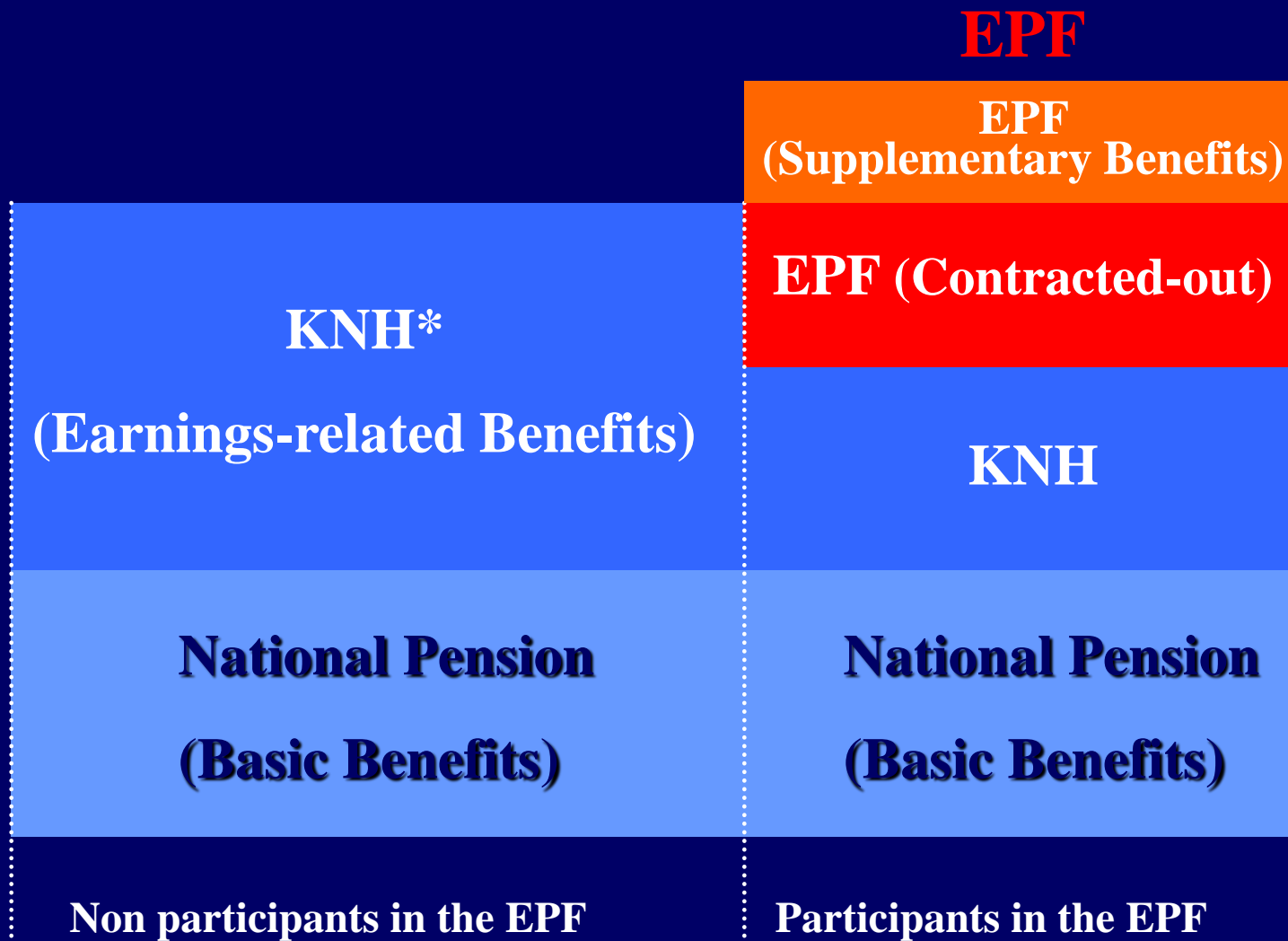
It is financed through a book-reserve system in which employers estimated the liability but do not set aside dedicated funds to pay the benefit. It is virtually managed on a pay-as-you-go basis within each employer.

Rise and Fall of the EPF (1)

The unique contracted-out plan of Japan was established in 1966. It is called the Employee Pension Fund (EPF). The benefits of the EPF consist of two components: the equivalent benefit of the earnings-related portion of the KNH (excluding the benefit resulting from indexing), and the supplementary benefit.

In return for paying the earnings-related old-age pension on behalf of the government, an EPF receives a contribution rebate. The contribution rebate (the payroll tax rebate) is between 2.4 and 5.0 percent from social security pensions, depending on each EPF's average age of their participants. The entire system under an EPF is called the *Daiko* system.

Rise and Fall of the EPF (2)



*KNH is the principal social security program for the private sector employees (the *Kosei Nenkin Hoken*).

Rise and Fall of the EPF (3)

Why the EPF was set up? The reason is as follows:

Namely, in the early 1960s, the pension bureau of Japanese government wanted to increase the level of KNH benefits, and accordingly its contribution rate, while employers were quite reluctant to accept this change, since they additionally had contributed a great deal to their own retirement programs on a private basis.

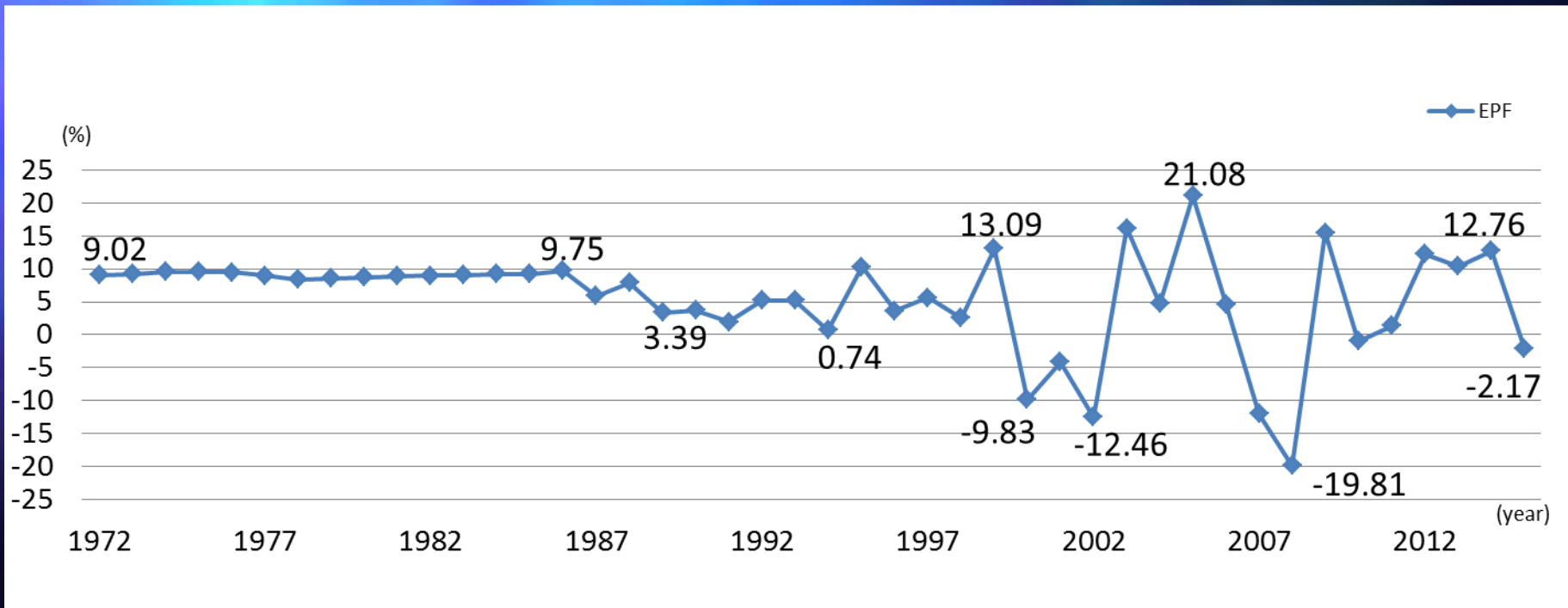
Rise and Fall of the EPF (4)

After long negotiations between the pension bureau and employers' group, there came a compromise. The hikes in both the level of benefits and the contribution rate were alright, but at the same time it was allowed for some employers to promise to pay the increased KNH benefits by adjusting their ongoing retirement programs to the new scheme.

The pension business industry welcomed this compromise, and the pension bureau were able to secure many plum jobs (such as the executive directors and the office managers in the EPF) for retiring officials.

Rise and Fall of the EPF (5)

Rate of Return from Investment in the EPF (in nominal terms)



Rise and Fall of the EPF (6)

The contracted-out portion used to bring in extra profits to EPFs. Once the investment environment turned adverse, however, the contracted-out portion began to hurt EPF operation.

Employers must compensate for the investment loss derived from the contracted-out portion and recognize the projected value of benefits for the contracted-out portion on their books.

Many employers and trade unions lobbied for legislation that relaxes the requirements for EPFs to return the contracted-out portion to the original social security regime. Since April 2002, it has been possible for EPFs to do so (*daiko henjo*).

Rise and Fall of the EPF (7)

The number of the EPF was 142 at the outset. It had once steadily increased up to 1,883 in 1996, but for the past 20 years it has been decreasing to 199 in August 2016, covering 2.1 million employees. The proportion of the participants in the EPFs over total number of the private sector employees was near 37% in 1996, but it fell down sharply to around 16% in 2004, falling further to 8.3% in 2015. The *daiko henjo* amounted to 1239 by August 2016.

The total amount of EPF asset holdings had steadily increased up to JPY 63 trillion (USD 630 billion) in March 2002. It fell down sharply to JPY 26.6 trillion (USD 266 billion) in March 2015.

Rise and Fall of the EPF (8)

The Number of the EPF

Fiscal Year	Number	Fiscal Year	Number
1966	142	2000	1,801
1986	1,134	2004	799
1996	1,883	2016	199

Source: Pension Fund Association, Japan

- **Lesson 2: Success and failure of funded pensions crucially depend on their investment performance. Funded pensions will be promising under high economic growth periods, while they face difficulties in an economic downturn. This is also true for a pay-as-you-go pension.**