AIJ Scandal and the Future of Occupational Pensions in Japan

Masaaki ONO[1]

Abstract

The year 2012 was a chaotic year for occupational pensions in Japan. The scandal of AIJ, an investment advisory firm, triggered the public criticism with regard to the financial issues and the sustainability of Employees' Pension Fund (EPF) scheme, one of the main Japanese occupational pension systems.

Behind the criticism lies the unique characteristic of EPFs in that they substitute a part of benefits otherwise provided by Employees' Pension Insurance (EPI), the social security pension system for the private sector workers.

In this paper, I will commentate on the turmoil caused by AIJ scandal, and issues of the financial structure of EPFs. I will also present pros and cons of EPF system, and finally, propose some ideas to preserve the scheme.

The contents of this paper are as follows.

* Current overview of Pension Systems in Japan
* Historical background and Outline of EPF scheme
* Financial structure of EPFs
* Outline of AIJ scandal and the raised concerns
* Government Committees and the controversial issues
* Some measures for the preservation of EPF scheme

Keywords

Employees' Pension Fund (EPF), Substitution, Financially neutral, Minimum Reserve, Occupational pension scheme for Small and Medium-sized Enterprises (SME)

---

[1] Research Fellow, Mizuho Pension Research Institute (MPRI)
Address: 1-17-7 Saga, Koto-ku, Tokyo, 135-0031 Japan
E-mail: ono@mizuho-pri.co.jp
Masaaki Ono joined the MPRI in 1998. His area of research interest is the development of public and private pension systems in Japan and abroad. Before joining the MPRI, he performed actuarial services, such as actuarial valuations and ALM, for occupational pension plans in the Mizuho Trust & Banking Co. Ltd., the parent company of the MPRI. Mr. Ono holds a Fellow of the Institute of Actuaries of Japan and a Certified Pension Actuary. He is a member of the subcommittee of the Pension Committee in the Ministry of Health Labor and Welfare (MHLW) for setting economic assumptions to be applied in the projection of public pension systems. He was a member of the advisory committee in the Pension Bureau of MHLW, which discussed the future of Employees' Pension Funds (EPFs). He is a visiting lecturer at Meiji University and Nihon University.

1. Current Overview of Pension Systems in Japan

1.1 Outline of the Social Security Pensions in Japan

Pension policies in Japan are based on the universal coverage principle. National Pension (NP), which provides the first tier benefits called "Basic Pensions", covers whole population aged from 20 to 59 as active participants regardless of each individual's earnings. The monthly amount of the old age basic pension for an individual with 40 years covered period is ¥65,541 (FY 2012).

Individuals who are not covered by employees' pension schemes, the second tier social security schemes such as EPI and Mutual Aid Associations (MAAs), are obliged to pay the flat rate contributions to NP (¥14,980 per month per capita in FY 2012). If the income of the participant or that of his/her householder were less than prescribed levels, he/she would be entitled to the fully or partially exemption from paying contributions.

Roughly half of the first tier benefits are financed by the Government's subsidies. Accordingly, if a participant had a covered period during which his/her contributions were fully exempted, the basic pension would be proportionately halved for that period. For example, if a person had covered period of 40 years, in which 10 years were approved as fully exempted period, his/her monthly old age basic pension benefit would be ¥57,348 (= (30+0.5*10)/40*¥65,541).

Employed individuals are covered by employees' pension schemes and, along with their employers, have to pay their contributions to his/her covered scheme. For the case of EPI, contributions are 16.766% of covered earnings in FY 2012, and the cost is equally shared by employers and employees. Because the cost for the first tier benefits is included in the contributions, employees and employers do not have to pay the flat rate contributions mentioned above.

Each second tier scheme is required to pay to the Basic Pension Account the amount for the payment of the first tier pensions on behalf of each covered participants. The amount for each scheme is determined so that all schemes share the burden proportionately to the number of each scheme's active participants. Accordingly, matured plans, such as NP, would be shored up by other schemes.

The cost of basic pension benefits for the dependent spouses of the covered employees is also covered by the same scheme.

It shall be deemed that the contributions of the married employee with his/her dependent spouse are equally shared between the couple. Thus, the dependent spouse is deemed to contribute half of her/his spouse's contributions as if she/he were employee, and credited for the basic pension benefit. Regarding the second tier pensions, earning related pensions, the benefits for marital period may be equally divided between the participant and his/her spouse in the case of divorce.

Employees' Pension Insurance (EPI) is the largest second tier social insurance pension program. EPI covers virtually all employees in the private sector. Employee who works less than three quarter of full-time workers is excluded from EPI and covered by NP or covered by the partner's second tier schemes as a dependent spouse if her/his earning were less than prescribed amount. Net replacement rate for the modeled couple, an employee with average earnings covered by EPI for 40 years and his/her dependent spouse, is estimated at 50% in 2038. The benefit formula for old age pension without transitional treatments is defined as the average revaluated covered earnings multiplied by the covered period and 0.5481%.

Social security pension schemes in Japan had been improved in the era of the high economic growth. Benefit levels were frequently raised until 1970s and the indexation provision was introduced in 1973. Reform proposals aiming to adjust for the graying society came into existence from 1980s. National Pension, which was originally introduced as the scheme for self-employed and other non-employed persons, was merged with the flat rate benefit portion of the then EPI and MAAs and became the platform of the first tier benefit for all insured persons in 1986. Regarding employees' schemes, pensionable age for the flat rate benefits was raised gradually from 60 to 65 in 1994 and for the earning related benefits in 1999. Accordingly, males born on April 2, 1961 or later and females born on April 2, 1966 or later will receive both flat rate and earning related old-age pension benefits from age 65. In 2012, the law aiming at the merge of employees' schemes, such as EPI and MAAs, was passed as one of the reform measures and they will be merged in 2015.

Social Security Pension schemes have huge amount of pension assets. For example, Government Pension Investment Fund (GPIF), which is an independent administrative institution, manages about ¥116 trillion (as of March, 2011) pension assets for EPI and NP. GPIF is known as the world largest pension fund.

1.2 Outline of the Private Pensions in Japan

Regarding occupational pension schemes, there are 2 types of Defined Benefit Schemes, Employees' Pension Funds (EPFs) and Defined Benefit Corporate Pensions Plans (DBPs), and Defined Contribution Scheme, named (Occupational type) Defined Contribution Pension Plans (DCPP).

As Tax Qualified Pension Plan (TQPP), which was one of the main defined benefit type plans, had been scheduled to lose the tax advantageous status in 2012, there is virtually no TQPPs.

EPFs have a very unique benefit structure in that they have an intersection between EPI called "substitution portion", which will be described in detail. As EPFs substitute a part of benefits of EPI, they enjoy better tax advantages than other external funding schemes. For example, survivor's benefits are fully tax free, contributions born by employees have a better treatment than that for TQPPs and DBPs. Special corporate taxes are virtually not levied on pension assets held by EPFs, while they are levied on TQPP, DBP, and DC assets although the taxation has been suspended from 1999 as a result of economic downturns and poor investment performances.

DBPs are introduced in 2002 and assumed as succession plans for TQPPs and EPFs which transferred the substituted benefit obligations and corresponding assets to the government. Japanese government aimed at the improved benefit security by imposing enhanced regulations with regard to the funding discipline, so-called fiduciary duties, and the disclosure to plan participants.

There are two pension schemes for self-employed individuals and employed individuals who are not covered by occupational pension plans. National Pension Fund is a kind of personal annuity scheme operated by local-base or professional-base national pension funds together with National Pension Fund Association (NPFA). This scheme aims at top-up benefits to NP for self employed individuals. Individual type DC plan is designed as a defined contribution pension plan for self-employed individuals and employed individuals who are not covered by occupational pension plans, and is operated by NPFA.

Beside the above plans, there are also other benefit schemes or retirement saving scheme. For example, Retirement Lump-sum Plans are the unfunded defined benefit termination (severance) lump-sum plan financed by the book reserve in the sponsoring company's balance sheet[2]. Japanese insurance companies sell annuity products. Many companies provide saving schemes for their employees. These plans are outside the scope of this paper.

1.3 Current Position in Global Comparison

According to the statistics provided by OECD[3], Japan's current position of retirement provisions in global comparison seems to be relatively poor.

OECD reports that Japan's gross replacement rate of the social security old age benefit for the standard employee, who has been covered by the scheme from 2005, would be 34% of the worker's average earnings[4]. Japan belongs to the group of the lowest replacement rate countries, such as UK, Ireland, and USA.

There seems to be a trend in that the lower the replacement rate, the higher the coverage ratio of voluntary private pension plans. Nevertheless, Japan's replacement ratio of 45% is much lower than those of its counterparts.

The situation seems to be more serious if we compare the ratio of the total assets of private pension plans to the country's GDP. The total assets of private pension plans in Japan account for only 20% of GDP, while the ratios of UK, Ireland and USA are around 100% or more.

We should note that these figures stand only for the external funding private pension plans. Because Japan has not only external funding schemes but also the scheme financed by the sponsoring company's book reserve (Retirement Lump-sum Plans) and they are fairly popular, the situation would be somewhat better.

2. Historical background and Outline of EPF system

2.1 Introduction of EPF system

---

[2] The tax advantageous status of the book reserve for Retirement Lump-sum Plans had been gradually eliminated from 2002.

[3] Pensions at a Glance: Public Policies across OECD Countries 2007 Edition - OECD © 2007, OECD Private Pensions Outlook 2008 - OECD © 2009

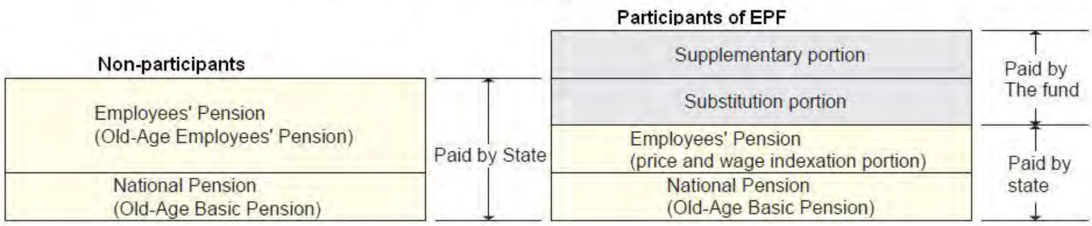
[4] Government released the official replacement rate of 50.1%. The rate is based on the net earnings and also based on the family unit which consists of a standard employee with average earnings and his/her dependent spouse throughout his/her insured period of 40 years. Accordingly, the rate would be somewhat lower if the basis were changed to the gross earning and a standard single worker.

Employees’ Pension Fund (EPF) was introduced by the revision of the Employees' Pension Insurance Law in 1965. In the era of high-speed economic growth, Japan sought to raise the benefit level of the public pension system. However, as many Japanese companies already had traditional retirement lump-sum schemes, which were financed by the book reserve of the company’s balance sheet, business communities, such as Japan Economic Federation, argued that they could not support the benefit hike policy without adjusting the lump-sum schemes. Financial institutions, such as trust & banking companies and insurance companies, were inspired by the US “pension drive” in early 1950s and urged that Japan should introduce the external funding systems for occupational pensions. On the other hand, labor unions opposed the policy claiming that adjusting social security pensions with companies’ lump-sum benefit plans means a kind of privatization and the benefit hike should be attained via social security pensions.

In the event, while the level of social security pension benefits was raised and the EPF scheme was introduced as an adjustment vehicle, whether to adjust the benefits with the retirement lump-sum systems was left to the business judgment of each employer, and, as a result, few employers did so.

EPF is a special corporation established with the approval of the Minister of Ministry of Health, Labor and Welfare (MHLW). The fund substitutes a part of the Old-Age Employees’ Pension (the earning related portion excluding the indexation) and pay its own supplementary benefits.

Structure of Employees’ Pension Fund Benefits



2.2 Outline of EPF system

2.2.1 Substitution and Exempt Premium

For example, if a person worked for Corporate A, B, and C in his career and earned pensionable wage, his/her earning related old age benefit of EPI is calculated by revaluating past wages in the three companies using the wage index, accumulating his/her revalued wages, and multiplying the constant value of 54.81 basis point. The pension benefits of EPI will be indexed in conjunction with CPI.

If only Corporate B provides EPF, the EPF will pay the earning related old age pension corresponding to the covered period in Corporate B without the wage indexation. EPI will pay the rest of his/her old age pension.

In addition to the substituted part in EPI, EPFs provide additional benefits most of which are designed as a transfer of the employer’s retirement lump-sum benefit plan. As retirement lump-sum plans define the amount of lump-sum at the point each employee leaves the company, the benefit formula of old age pensions is designed as a conversion of the lump-sum to the annuity by using assumed interest rates over the deferral and decumulation phase. This plan design might be similar to "pension equity plans" in US.

The employer who establishes EPF and its employees are exempted from paying part of contributions to EPI in return for the substitution (exempt premium). The exempt premium should be paid as a part of contributions to EPF. While this structure might be similar to "contract out" in UK, the substitution in EPF differs in the following aspect.

- Substitution only for old-age pension (no disabled or survivor's benefits)
- Revaluation and indexation factors are excluded
- Ceasing to substitute for future service is prohibited except in the case of plan termination

2.2.2 Management of EPF

EPF is a legal entity established on the basis of agreement between the employer and its employees. EPFs are regulated by Employees' Pension Insurance Law, which provides social insurance pensions for private sector employees, and supervised by MHLW. Board of representatives, which decides its plan provision, business plan, and budget, consists of the delegates of the same number from both employer(s) and employees. Part of the members, also equally represented, organizes the executive board. There are some internal auditors.

Because EPFs play a part of EPI, they are deemed to be a kind of administrative agency of the government, and executives and employees of the EPF office will be treated as public employees in the case of application of the criminal law.

2.2.3 Implication of EPFs

EPFs serve for the improvement of funding level of Social Insurance Pension System as a whole. If an employer decides to establish EPF, the government would not have to pay the EPF's substituted benefits in the future. On the other-hand, government's contribution revenue would be declined by the exempt premiums for the EPF. As the exempt premiums are calculated on the prefunding basis, if we see the system as a whole, i.e. the substituted portion of EPFs plus the remaining EPI, government would have to raise the contribution rate to pay the exempt premium for the EPF and remaining benefits. The increase would be accumulated in each EPF, which would be seen as a part of EPI fund and improve the funding level of EPI as a whole. As the investments of the accumulated premiums are operated in each EPF, this scheme also solves the potential concerns regarding political issues in the management of pension funds by the government. There might be similar discussions between UK contract-out pension schemes and the state second pension scheme.

2.3 Development of EPF system

When Employees' Pension Insurance Law was revised and the EPF system was introduced in 1965, the formula of substituted benefits was defined as below.

$$Annual\,Benefit = 1\% \times career\,average\,of\ monthly\,wage \times number\,of\ months\,of\ participation$$

While the indexation mechanism was introduced in 1973 and past covered wages were revalued in the calculation of EPI benefits, the definition of substituted benefit in EPF was not changed and past wages were not revalued. Accordingly, EPI paid the difference, i.e. the old age benefits in excess of substituted benefits, as mentioned previously.

Although 20% of the above benefit was financed by the government's subsidy, there exist some technical problems for each EPF. EPI benefits were adjusted (reduced) for the earnings of working pensioners and 20% was applied to the adjusted benefits. But each EPF could not trace whether its former employee were still working in another companies and covered by EPI. As a result, EPFs uniformly provided unadjusted benefits for the former employees. In this case, government's subsidy was defined as 17.5% of unadjusted substituted benefits taking the adjustment into account. That is, it was deemed that 87.5% (=17.5%/20%) of the cost for unadjusted benefits would be the cost for adjusted benefits. But recently, as EPFs got to be able to access the former employees' status in Social Security Agency record via Pension Fund Association, EPF had been able to adjust those former employees' benefits and both benefits had become closer.

The 1% accrual rate in EPI was revised to be gradually lowered by birth cohorts to 0.75% in 1985. Government subsidies were limited to the transitional cohort whose accrual rate exceeds 0.8% for the past period and 0.75% for the future period. Because the former exempt premium corresponds to the cost for providing 0.8% benefits (=1%*(1-20%)), the government had to request each EPF to refund the excess cost for the past period for younger cohorts, which correspond to 0.05% benefit (0.8% - 0.75% in the case of youngest cohort). The government decided that the excess cost to be refunded by cancelling its subsidy for elder cohort's benefits. As EPI plan design changes, some adjustment between EPI and EPFs might be necessary, which makes the EPF schemes difficult to understand.

After the 1985 reform, 0.75% was revised to 0.7125% (=0.75%*95%) in 1999 and to 0.5481% in 2003. The latter revision was implemented with the change of definition of pensionable wage so that "bonus" should be included as well as monthly wages. As 0.5481% is obtained by dividing 0.7125% by 1.3, the revision would result in no change in benefit level for a person whose annual bonus equals to 30% of annual amount of monthly wages.

Pensionable age was also changed. When EPF system was introduced in 1965, pensionable age was 60 years for male and 55 for female. Pensionable age for females was changed in 1985 to be gradually raised to 60 by 1999. Although pensionable age for Basic Pension was scheduled to rise gradually to 65 in 1994, it did not affect the substituted benefits in EPF because EPI provides earning related benefits whose pensionable age remained unchanged. In 1999, the pensionable age for EPI was changed to be gradually postponed to 65. The substitution system in EPF was greatly affected, which will be explained in the next section.

3. Financial structure of EPFs

Since the introduction of EPF scheme, the main issue had been how to ensure the financial neutrality between EPI and EPFs. In this regard, it comes down to the valuation method for Exempt premium and Minimum Reserve.

3.1 Before the 1999 Pension Reform

As EPFs play a part of EPI by substituting the earning related part of old age pensions in EPI, employers and employees are exempted from paying a part of the EPI premium, which we call "Exempt Premium" to EPI. Employers have to pay the exempt premium as a part of contributions to their EPFs.

Exempt Premium had been established by the government as a uniform rate to all EPFs. Until 1994, the rate had been reviewed every 5 years taking the revised mortality rates and the demographics of EPI participants into account. The rate had represented the cost of substitution for all covered participants in EPI using the then current mortality rates and the discount rate of 5.5% per annum. This system caused a kind of adverse selection for employers as to whether to establish EPF. For example, because young companies could afford to provide the substituted benefits at a lower cost than the uniformly defined exempt premium, they could provide additional benefit by using a part of exempt premium in excess of the company's own cost for the substituted benefits. This situation would provide the incentives to establish EPF for these companies. But as the demographic structure of sponsoring companies aged and the 5.5% discount rate became harder as an investment performance target, this advantage turned to disadvantage for many EPFs.

In 1994, the system was changed so that the effect of adverse selection was to be eased. Each EPF have to determine its own exempt premium. Certified pension actuaries calculate each EPF's exempt premium by using prescribed interest rate and mortality rates, specified funding method (Open Aggregate Normal Cost Method), and its inherent salary increase rates, decrement rates, and employee's demographics.

Even if the exempt premium were defined by the pre-1994 method, the financial neutrality would have been attained by the definition of Minimum Reserve. Minimum Reserve is the liability of the EPF to the government if it were to be terminated. If Minimum Reserve were defined as the compound value of each year's exempt premium, (minus) substitution benefits, and interest which correspond to the each year's investment performance of GPIF, the financial neutrality had been attained. This means that Minimum Reserve is the amount calculated retrospectively assuming that the exempt premiums were managed by GPIF, and also means that Minimum Reserve is a kind of deposit for GPIF to EPF.

But there was a technical problem. Because each EPF could not trace former employees' status in EPI, that is whether they were working pensioners or not, EPF could not determine the substituted benefits precisely. So the government gave up this method and adopted the actuarial liability based on the Traditional Unit Credit (TUC) method[5] for the definition of Minimum Reserve.

3.2 Pension Reform in 1999 and Minimum Reserve

After the collapse of Bubble Economy, Japanese economy went into the deep confusion from late 1990's. For example, Yamaichi Securities, Japan's then fourth largest security company, went into bankrupt in 1997, and Long-term Credit Bank of Japan got the capital injection by the government and became nationalized in 1998. The quinquenial review and the pension reform were carried out at this time. Due to concerns on economic recoveries, the government decided not to raise the contribution rate of EPI. As a result, the contribution rate had been virtually frozen until 2004.

This political decision also affected the substitution system in EPFs. According to the government, because the contribution rate of EPI was frozen, the exempt premium also had to be frozen and the actuarial valuation for the substituted part in EPFs lost the ground for using the updated actuarial assumptions to be applied to EPI. As previously described, Minimum Reserve had been calculated using Traditional Unit Credit Method and 5.5% interest rate, which far exceeded the market bond yields in the business depression era.

The government decided to change the definition of Minimum Reserve. The revised definition was as follows. The Minimum Reserve at the end of September 1999 was calculated using the then current method. The Minimum Reserve for the subsequent valuation date was defined as the principal with interest assuming that the September 1999 liability and the related cash-flows (exempt premiums as in-flows and substituted benefits as out-flows) were to be invested in GPIF to that date. If an EPF were to be terminated, it had to pay back the Minimum Reserve as of the termination date to the government[6]. This change of definition of the liability accomplished a kind of financial neutrality between EPF participants and non EPF participants. Although there was also an alternative method in which the liability was calculated using the cash-flow from the establishment of each EPF, the difference between the two methods was not so material. As a result, few EPFs use the latter method.

3.3 New Corporate Pension Law

Owing to the prolonged economic turmoil, low interest rates, poor investment performances on pension assets etc, plan sponsors of EPFs became to feel it a serious burden for them to provide the substituted part of EPI, and requested to return it to the government. In 1998, Japan Federation of Employers' Associations proposed the elimination of the substitution system and transitionally the return of the part of assets and liabilities in EPFs, which relate to the substituted benefits, to the government. Federation of Economic Organization subsequently joined the proposal.

Accordingly, when new Defined Benefit Corporate Pension Law was promulgated in 2001, the law

---

[5] Theoretically, actuarial liability based on TUC and that based on Open Aggregate Normal Cost Method are identical in the stable demographics.

[6] More precisely, EPF should transfer the minimum reserve to Pension Fund Association (PFA). If PFA were to be terminated, the minimum reserve should be transferred to the government.

provided that EPFs could return to EPI the obligation to provide the substituted benefits. In this case, EPF has to transfer the corresponding asset, which is equal to the liability mentioned above (Minimum Reserve), to EPI. The provision made a phenomenon called "Daiko-Henjo[7]". Most single-employer EPFs utilized this option and those EPFs became Defined Benefit Corporate Pension Plans, DB plans without substitution of EPI.

3.4 Pension Reform in 2004

Pension reform in 2004 was epoch-making. It prescribed the schedule of the contribution hike, set the upper limit of the contribution rate, and introduced so-called Macro Economic Indexation, which is the benefit adjusting mechanism based on the long term financial position of the scheme. It also introduced rules of Pension Division between couples in the case of divorce.

Regarding the substituted part in EPF, there were several changes. Because the contribution rate freezing was reset, exempted premiums were to be calculated based on the revised scheme design and updated actuarial assumptions. Because the pensionable age was gradually postponed to 65, the exempt premium, applied from April 2005, was defined as the cost for providing substituted benefits from age 65. The part of substituted benefits for transitional participants, which correspond to the covered period from April 2005 and the payments during the first half of age 60s, were to be provided by the government subsidies.

Although the 1999 definition of Minimum Reserve for substituted benefits was unchanged, there had been a concern. As the September 1999 liability was calculated using 5.5% interest rate and the GPIF's investment performances thereafter were mostly below that level, there existed a possibility that Minimum Reserve under the new definition might run out in some future. Accordingly, the government decided to raise the liability by putting some amount of money to EPF as a deposit if Minimum Reserve fell below the certain level.

The government also redefined funding targets for the substituted part in EPF by setting the Minimum Reserve for both continuous base and discontinuous base. In the case of plan termination, the termination liability for the substituted part was also defined as above.

Accordingly, regarding the substituted part, EPFs would not have the excess liability over the Minimum Reserve in any case such as continuing management of the plan, deciding Daiko-Henjo, and deciding termination. If the EPF adopts the investment strategy similar to that of GPIF, it will expose to nil investment risk.

3.5 Some Remaining issues for Financial "Neutralization"

Although I mentioned that the financial neutralization had been accomplished, there remain two technical issues for the scheme to complete "pure" neutralization.

First issue regards the application of GPIF's investment performance to the Minimum Reserve in EPFs. According to the government, in order to apply GPIF's performance of a certain fiscal year,

---

[7] Literally, Japanese word "Daiko" means "substitution", and "Henjo" means "sending back".

GPIF's financial statement for the same fiscal year must be approved and confirmed, and Ministry of Health, Labor and Welfare (MHLW) has to submit the financial report of GPIF, as a part of the special account for EPI, to the General Accounting Office by the end of November. Accordingly, GIIF's investment performance for the previous fiscal year would be available from January of the current fiscal year as the rate to be applied to the Minimum Reserve, which makes the 21-months-lag to GPIF's performance. That is, GPIF's investment performance for the fiscal year 2010 (from April 2010 to March 2011) would be applied to the Minimum Reserve during the 2012 calendar year. Because the investment performance fluctuates each year, this treatment would be problematic for EPF's financial position and its investment strategy.

Historical Data of Investment performances in GPIF (EPI account)

Fiscal year*	1997	1998	1999	2000	2001	2002	2003
Performance	4.66%	4.15%	3.62%	3.22%	1.99%	0.21%	4.91%
Fiscal year	2004	2005	2006	2007	2008	2009	2010
Performance	2.73%	6.82%	3.10%	-3.54%	-6.83%	7.54%	-0.26%

* From April to March in the succeeding year

The treatment had been eased from the fiscal year 2009. The 21-months-lag was eliminated in Minimum Reserve as the continuous base funding target (Continuous base Minimum Reserve). Minimum Reserve and corresponding assets in EPF would move parallel by this revision if the investment strategy of the EPF were similar to that of GPIF and the EPF would expose almost no investment risk to that extent. On the other hand, the definition of Minimum Reserve as discontinuous base and the termination liability for substituted benefits in both Daiko-Henjo and plan termination remained unchanged.

Second issue is derived from the definition of substituted benefits. As previously described, because it is technically difficult for each EPF to trace whether former employees were still covered by EPI in another companies, each EPF deems 87.5% of substituted benefits without adjustment for working pensioners as substituted benefits in EPI. While the Minimum Reserve would be reduced by the deemed benefits when due, corresponding assets were reduced by the amount actually paid. If the two amounts were different, the difference would cause the actuarial gains and losses. As it's often the case that the latter amount exceeds the former one, the difference tends to be actuarial losses. Because many EPFs have made effort to close the gap by accessing each pensioner's record in EPI, the current treatment and the constant 87.5% should be revisited.

4. Outline of AIJ scandal and the raised concerns

4.1 Outline of AIJ scandal

AIJ scandal was quite simple. It is like the Ponzi scheme of Bernard Madoff.

On February 24, 2012, Financial Services Agency (FSA) imposed the business suspension order (from 24 February to 23 March) and the business improvement order, which includes the followings, on AIJ Investment Advisors CO., LTD (AIJ).

- comply with Securities and Exchange Surveillance Commission (SESC)'s inspection
- assess clients' assets
- do not expense company asset without due course
- report above results to FSA until 23 March

Subsequently, on March 23, FSA imposed the administrative punishment to discharge the registration of AIJ as an investment advisory firm, and the following business improvement order on AIJ.

- explain properly about the administrative punishment to its clients
- cooperate on the activities to maintain the clients' assets in accord with the clients' intents
- provide its clients timely and properly with the information necessary to maintain the clients' assets

During the inspection, SESC found the following violation of Law (Financial Instruments and Exchange Law) by AIJ.

- providing potential clients with false reports in the net asset value of "AIM Global Fund" and its sub-funds, conducted by its president, in its sales activities aiming at making Discretionary Management Contracts
- providing its clients with false investment performance reports
- submitting false business reports to Kanto regional financial bureau
- violation of the fiduciary duty of loyalty (ex. payments based on purported returns to existing investors from funds contributed by new investors)

SESC accused 3 persons, including Mr. Asakawa, the president of AIJ, on July 9, 30, September 19, and October 5 of above frauds. In response to SESC's accusations, Tokyo District Public Prosecutors Office prosecuted them. The court proceedings started on December 5, 2012.

According to the court procedure, AIJ invested ¥146bil in the Cayman based investment funds managed by AIJ's related company, AIA. The fund lost ¥110bil by option trading. Most of the remaining assets had been paid to the former clients who required withdrawing, and there remains only ¥9bil.

AIJ's main clients were pension funds, most of which are EPFs, especially multiemployer EPFs. 84 pension funds, of which 74 funds are EPFs and 10 funds are DBPs, invested to AIJ's investment funds. Furthermore, 73 of the 74 EPFs are multiemployer EPFs.

Although more than half of EPF clients invested less than 10% of total asset in AIJ, significant portions of total asset were invested by some EPFs, which might be against to the diversification policy in the investment strategy.

4.2 Raised concerns

As previously described, Minimum Reserve of EPF is considered as a deposit for EPI, and it is incorporated in the fiscal outlook of EPI as an asset. If EPFs with assets less than Minimum Reserve were to exist, it might cause a loss for EPI in future.

Prolonged economic slump and bad investment performances, together with the high risk exposure in the investment strategies of EPF, caused the Minimum Reserve shortfall in many EPFs, especially in the year 2003 and 2009, which are immediately following the "perfect storm" and the global financial crisis.

AIJ scandal triggered the concern and attracted public attention. These concerns made a severe tension within EPI, between those within and without EPFs. The then governing party, Democratic Party of Japan (DPJ), set up a working team in March, and published some proposals including the elimination of EPF scheme in April. MHLW also set up a task force headed by the then vice minister. It decided to set up the advisory committee to deal with the concern.

5. Government Committees and the controversial issues

5.1 Advisory committee in Pension Bureau of MHLW

Pension Bureau of MHLW organized the advisory committee which consists of members from pension funds (DBP and EPF), Pension Fund Association, Japan Business Federation, Japanese Trade Union Confederation, academic sectors in economics and labor law, and research institutes. The main agendas were as follows.

- Regulations regarding Pension Fund Investment
  - Fiduciary duty (diversified investment, duty of care, duty of loyalty)
  - Decision making structure (quality, process, use of consultants, relation between money managers and custodians, disclosure, etc.)
  - Internal audit and supervision
- Financial Issues of Pension funds
  - Setting discount rate, and how to cope with funding shortfall
  - Criteria on benefit reduction and plan termination
- EPF's future
  - Significance of Substitution scheme
  - How to cope with Minimum Reserve shortages
  - Multiemployer EPF and pension policy for SMEs

The committee meeting was held from April and the committee published the report at the beginning of July. The most controversial issue was whether to preserve EPF scheme in future. Advisory committee reported that there were pros and cons to the issue. The main point of the committee member against EPF was the potential adverse financial effect to EPI. EPF scheme causes the risk for EPI by the possibility of funding shortfall to Minimum Reserve. So the scheme should be eliminated sometime in the future. Meanwhile, the main point of the members for EPF was the concern to employees in Small and Medium Sized Enterprises (SMEs) if EPF scheme were to be eliminated. They claimed that EPF scheme, especially multiemployer EPFs, played an important role in spreading pension plans among SMEs. If EPF scheme were to be eliminated, private pension schemes would be criticized that they are mainly for full-time employees in large companies. So the scheme should be maintained.

Although majority of the members were negative to the elimination, the then Vice Minister , as the head of Ministry's working team, announced ministry's plan to abolish EPF in future on September 28. He also expressed the intent to set up the ministry's expert committee under Pension Council in Social Security Council.

5.2 Expert committee under Social Security Council

The first meeting of the committee was held on November 2. At the meeting, MHLW proposed a plan, which includes the following proposals.

- How to cope with the funding shortfall to Minimum Reserve
  - Easing the obligation to make up the funding shortfall by setting some limit, while pressing financially distressed EPFs to terminate
  - Abolishment of the Joint Obligation among the sponsoring employers in the case of plan termination of multiemployer EPFs with Minimum Reserve shortfalls
- Proposals for sustainable pension plans
  - Easing regulations on plan design (such as adding options of the interest credit rates in Cash Balance plan, and introducing a collectively managed DC plan)
  - Measures to encourage the shift from EPFs to pension plans of other types
- Examining the substitution scheme in EPF
  - Fine-tuning the definition of the Minimum Reserve, which has an effect of lowering the amount
  - Two step process to eliminate EPF scheme; first to encourage termination for EPFs with MR shortfalls, and shift to other pension plans for EPFs without MR shortfalls in the first 5 years; then enforce to stop exempt premiums and future accruals of substituted benefits, and to implement "Daiko-Henjo" or to terminate the plan in the next five years

But the lower house election was held in last December, and DPJ was completely defeated and Liberal Democratic Party (LDP) recaptured power. Expert Committee's report was published in February, which was generally favorable to the MHLW's proposal with reference to the minority's opinion advocating that "financially sound EPFs" should be preserved.

Because LDP is negative to the uniform elimination, MHLW seems to be changing its direction to preserve "financially sound EPFs". But it tries to set very tough criteria in the definition of "financially sound EPF" such as EPF with assets more than 150% of Minimum Reserve. If this standard were to be applied, only 10% of 560 EPFs could survive, that seems to be the virtual elimination. The 150% criterion is based to the investment strategies and investment performance experiences of all EPFs in the decade including 5 years of negative investment returns. MHLW analyzes that based on the past experiences the 50% buffer will be required to keep plan assets above Minimum Reserve for 2 years.

6. Some measures for the preservation of EPF scheme

6.1 What caused the current challenges?

Although AIJ scandal is a very serious issue, there seems to be several factors that caused the current challenges.

6.1.1 Governance of multiemployer EPFs

In general, the plan management of multiemployer plans tends to adapt to the most vulnerable employer. Multiemployer EPFs might have avoided contribution hikes, delayed the decision-making, and adopted higher risk exposures in their investment strategies to restore the financial soundness. As previously described, the substitution portion of EPF would cause virtually no financial risk to EPF as long as it adopts the same investment strategy of GPIF by the revision of the definition of Minimum Reserve in 1999. Taking that 80% of EPF benefits are substitution benefits on average and GPIF adopts a very conservative strategy[8], EPFs need not take a high risk exposure. Nevertheless, the asset mix of typical EPFs takes much larger investment risk than GPIF[9], which caused financial difficulties of EPF in the recent decade.

6.1.2 Rules that lack the elaboration

Another reason for the high risk profile of EPFs may be attributed to the lack of elaboration in the prescribed funding rules. The government set the 21-months-lagged interest rate for the calculation of Minimum Reserve. The lagged Minimum Reserve had generated the maximum 18% difference to Minimum Reserve without lag in some year, and EPFs had to be conscious of the past investment performances of GPIF. Also, the government had never revisited the adjustment factor of 87.5% for working pensioners since the introduction of EPF scheme in 1965. These factors might have acted as an obstacle for many EPFs to understand the concept of the financial neutralization between EPI and EPFs. We should keep “God is in the details.” in mind.

6.2 Risk-based criteria

We should avoid taking inappropriate criteria and set the risk-based criteria. In order to achieve this goal, we should firstly realize the “pure neutralization” so that EPF will never expose to financial risk of the substitution portion as long as the investment of EPF is the same as that of GPIF.

In this regard, the investment performance of GPIF should be measured completely at fair value basis. The current performance measurement method in GPIF is partially based on the purchase

[8] The current policy asset mix of GPIF is 67% for Domestic Bonds, 11% for Domestic Stocks, 8% for Foreign Bonds, 9% for Foreign Stocks, and 5% for Cash Equivalents.

[9] EPFs as a whole invest 23% of the total assets to Domestic Bonds, 22% to Domestic Stocks, 11% to Foreign Bonds, 19% to Foreign Stocks, 10% to Insurance Company’s General Account, 6% to Hedge Funds, 4% to Cash Equivalents, and 4% to Other Investments at the end of March 2012.

price and amortized cost method for securities to be held to maturity.

The uniform 150% criterion is not appropriate and it should be changed so that it is based on the difference in investment strategies between each EPF and GPIF. The risk exposure of the substitution portion of each EPF will be the risk of its excess return over that of GPIF.

Assuming these revisions were to be attained, the question will be whether each EPF is able to make up its Minimum Funding shortfall in a given period. In some case a highly political decision might be required. What we learn from the history is that forcing poor funds to exit will contribute to the soundness of the scheme as a whole.

6.3 Occupational pension scheme for SMEs

If EPF scheme were to be eliminated, it would become a serious problem for SMEs, because SMEs covered by occupational pension plans are mainly covered by EPFs. This issue will not remain only in SMEs. Although the coverage ratio of occupational pension plans for SMEs is much less than that for larger companies, the elimination of EPF scheme will sharpen the disparity.

These issues will raise the concern that the ground of tax advantageous status of external funding pension schemes might be weakened. Some person points out that the two pillar concept, in which occupational pension schemes belong to the second pillar together with individual plans, might be better than the traditional three pillar concept. Otherwise, we might lose the current tax treatment for all external funding occupational schemes if we take the current severe budget constrains into account.

Even if EPF scheme were to be eliminated, the successor scheme for SMEs should be provided. The current government reports are not sufficient in this regard and further discussion will be needed.

Taking that the single employer defined benefit plan is difficult to provide for each SME, some improvements to multiemployer-type plans will be needed. They might be the improvement in plan design, funding standards, or legal status of pension funds.

With regard to plan design, I think that even in occupational pensions, the advance consensus formation for the ex-post redistribution among related parties, such as employers, employees, and also retirees might be essential for sustainable pensions.

Funding standards for multiemployer plans would be a big challenge. I understand that, as many developed countries have entered into the low interest rate era, funding issues of multiemployer plans have grown to an important problem for many of those countries.

According to the current Defined Benefit Corporate Pension Law, the authority of DB pension funds to levy the contributions is much weaker than that of EPFs. While EPFs are government agencies and have a strong authority to collect contributions next to national tax agencies, the status of DB pension funds to the covered employers is the same as a general creditor to them. Unless the status of DB pension funds were somewhat improved, the management of multiemployer DB pension funds might be deadlocked.

6.4 Concluding Remarks

Although the total individual financial assets in Japan exceed 3 times of its GDP, private pension assets in Japan are much less than those of many western countries. Given the growing percentage of non regular workers, "coverage" might be a major issue for the occupational pension policy in future. In contrast to US and UK, defined benefit plans still dominate the occupational pension field in Japan. Part of the reason might be attributed to its flexible criteria, such as the benefit reduction, which is a kind of ex-post redistribution consensus among related parties.

Discussion of EPF's future should be based on the accurate fact-findings. In my opinion, an appropriate "maintenance and repair" will be much more efficient than the "scrap-and-build".

Given the current severe economic situation, we should never forget that if a defined pension scheme were to be terminated it will never revive. All Japanese people learn the proverb "It is no use crying over spilt milk" in junior high-schools.