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The potential market for defined-contribution pensions

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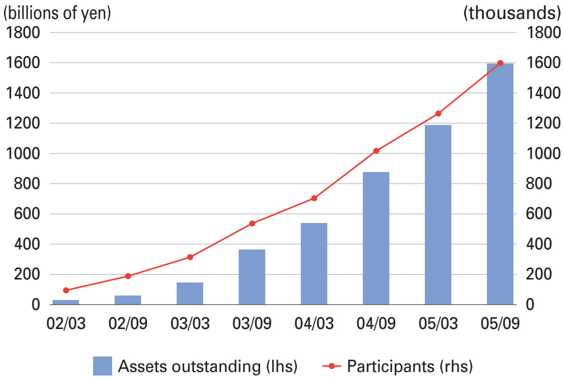
Assets in defined-contribution pensions have increased steadily since Japanese pension laws were amended to allow them. The potential for further growth exists given possible migration from other pension plans and ongoing reviews of the legal framework.

Defined-contribution pensions post steady growth

Since Japanese pension laws were amended in October 2001 to allow defined-contribution pensions, assets under management in these plans have grown steadily. At the end of September 2005, there were 1.57 million participants in corporate defined-contribution plans[1] with outstanding assets of 1.6 trillion yen. Compared with traditional corporate pensions—the Employees' Pension Fund and defined-benefit plans—assets remain limited. But growth may accelerate in the coming years as tax-qualified retirement pension funds are abolished six years from now and other changes are made to the legal framework for pensions. This report surveys the key points on which further adoption of defined-contribution pension plans hinges.

Exhibit 1. Corporate defined-contribution plans: participants and assets outstanding



Source: Ministry of Health, Labour and Welfare, Newsletter on Pensions & Investment

Migration from other pension plans

We first surveyed the outlook for adoption of corporate defined-contribution pensions under the current legal framework. According to Ministry of Health, Labour and Welfare data on the migration of assets to corporate defined-contribution pensions, transfers from tax-qualified plans were the second-most common after newly established plans, accounted for about half of all such pensions.[2]

Tax-qualified pensions are set to be abolished in March 2012, forcing companies offering such plans to review their pension plans. Although some firms have already switched to other plans, tax-qualified pensions are still offered by about 50,000 companies and represent 17 trillion yen in assets outstanding.

Exhibit 2. Asset migration from other pension programs

(cases)

	05/10	Share
Employees' Pension Fund	28	2%
Defined-benefit plans	6	0%
Tax-qualified plans	595	38%
Retirement allowance	215	14%
Tax-qualified plan + retirement allowance	259	16%
Newly established	458	29%
Other	22	1%
Total	1,583	

Source: Defined-Contribution Pension Liaison Conference (Ministry of Health, Labour and Welfare)

The most likely destinations for funds now in tax-qualified plans are defined-contribution pensions and the Smaller Enterprise Retirement Allowance Mutual Aid Scheme (SERAMAS). Introducing a defined-contribution plan entails substantial cost and effort: negotiations must be held with the authorities when creating the program, the plan must be administered, and investment education must be provided for employees.[3] This is why relatively large businesses have been more likely to adopt such plans.[4] We tried to estimate future growth in corporate defined-contribution pensions, taking into account migration between plans thus far and the findings of surveys on company plans to offer such plans in the future. We assumed that inflows to corporate defined-contribution plans would be mostly from new participants and from employees switching over from tax-qualified plans. We based our estimate of the former on plans introduced in the last year. For tax-qualified pensions, our estimates were based on the hypothesis that the new plan type would be largely determined by the number of employees at the business and outstanding assets in the plan.[5] Based on these assumptions, we estimate that when tax-qualified pensions are abolished in March 2012, assets under management in defined-contribution plans will have risen about tenfold, to 12 trillion yen, with net inflows of about 8 trillion yen from tax-qualified plans. Note that these figures assume no change in existing pension legislation. If the various obstacles to adoption of defined-contribution plans (see below) are removed, the market is likely to see greater expansion.

We also expect to see some migration of assets from SERAMAS to defined-contribution plans. In February 2006 talks with the ruling party regarding the consolidation of employee pensions, a policy for the future was presented. In the event that pension supplements by occupation, a feature unique to SERAMAS, are abolished, the policy calls for the establishment of a pension plan equivalent to corporate pensions in the private sector. We expect future discussions to touch on the adoption of defined-contribution plans.

Limitations of the current system

While a steadily growing number of companies are offering defined-contribution plans, many are also choosing not to. Reasons include restrictions on early withdrawals, the relatively low limits on contributions,[6] and the fact that individual contributions are not allowed. The restrictions on early withdrawals in particular are often an obstacle. Under the current system, when an employee leaves a company mid-career, any assets in a defined-contribution plan must be transferred to the next employer's defined-contribution plan. If such a plan is not offered, the assets are transferred to an individual pension managed by the National Pension Fund Association and cannot be withdrawn until the individual turns 60. Some 80% of the respondents to a survey conducted by Fidelity Investments Japan and the NPO 401k Educational Society[7] cited the conditions for early plan dissolution and restrictions on early withdrawals as obstacles to the adoption of defined-contribution plans. In our view, the government needs to create a system that—like the 401(k) program in the US—allows employees to make early withdrawals upon payment of a penalty tax.

Individual defined-contribution plans

Another key issue for defined-contribution plans is the ongoing review of individual (as opposed to corporate) plans. Such plans are still small in scale relative to their corporate cousins: at the end of March 2005, there were only about 50,000 participants with outstanding assets of 50 billion yen. Persons eligible to participate in this system include individuals contributing to the National Pension Fund and employees of companies offering no corporate pensions. A number of factors have hindered their adoption, including a lack of awareness about the system, low ceilings on contributions,[8] and restrictions on portability.[9] While individual defined-contribution pensions resemble US Individual Retirement Accounts (IRAs) in many ways, they remain far less convenient to set up and use. IRAs, for example, allow contributions up to the age of 70.5, whereas in Japan participants can only contribute to such plans until they turn 60. If it were possible to transfer retirement allowances or assets accumulated in corporate defined-contribution plans to these plans, we think they would be much more popular. Some pension managers, anticipating increased future demand for individual defined-contribution plans, are now working to expand their sales organizations and prepare for greater fund inflows.

Changes to legal framework awaited

Abolition of the tax-qualified pension program will without doubt be the main driver of growth in defined-contribution plan assets over the next six years. Although problems with the current legal framework are widely recognized, concrete discussion with an eye to revising existing legislation has yet to begin, and there are no indications as to how long this process will take. But it is essential if defined-contribution pensions are to continue to grow over the longer term. In particular, we think discussions on easing restrictions on early withdrawals and on the use of individual defined-contribution plans are critical to greater acceptance of such plans. The supplementary provisions of the Defined-Contribution Pension Law contain a clause stating that once five years have passed after the enactment of the legislation, the Law will be examined and revisions made as necessary. This year marks the fifth since the law was passed. We await revisions to the legal framework that acknowledge changing work arrangements—such as the growing number of mid-career company leavers and an increase in the average age of hires—and clarify the role of corporate pensions vis-à-vis the public pension system.

Note

1) Current law provides for two types of defined-contribution pensions: corporate and individual. The former are managed by companies for their employees. Individual defined-contribution pensions are designed for self-employed individuals who contribute to the National Pension Fund and for employees of companies that do not offer corporate pensions.

2) Cases of transfers from tax-qualified pension or tax-qualified pension + retirement allowance as a percentage of all transfers.

3) So-called comprehensive plans have been increasingly popular among small businesses because they allow participation by a group of companies with no capital affiliation, offering easier management and lower costs than programs set up by individual companies.

4) "Retirement Payments and Pensions at Small Businesses," NLI Research Institute Report, March 2005.

5) We assumed that businesses with 300 or fewer employees would all shift to SERAMAS, that those with more than 300 employees but pension fund assets of less than 20 billion yen would switch to defined-contribution plans, and that those with more than 300 employees and pension fund assets of at least 20 billion yen would switch to a 50:50 combination of defined-contribution and defined-benefit plans.

6) Monthly contributions are limited to 23,000 yen when another corporate pension plan exists, 46,000 yen otherwise.

7) Presented at the Ministry of Health, Labour and Welfare's 14th Defined-Contribution Pension Liaison Conference. Based on the results of a survey conducted in 2005.

8) For self-employed individuals, contributions are limited to 68,000 yen less any contributions to the National Pension Fund. For company employees, contributions are capped at 18,000 yen.

9) When a participant in a corporate defined-contribution plan changes jobs, for example, and the new employer does not offer a defined-contribution plan but does offer another type of corporate pension (e.g., the Employees' Pension Fund), the assets can be transferred to an individual defined-contribution plan, but no new contributions are allowed.

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