

Corporate Pension After Pension System Reform

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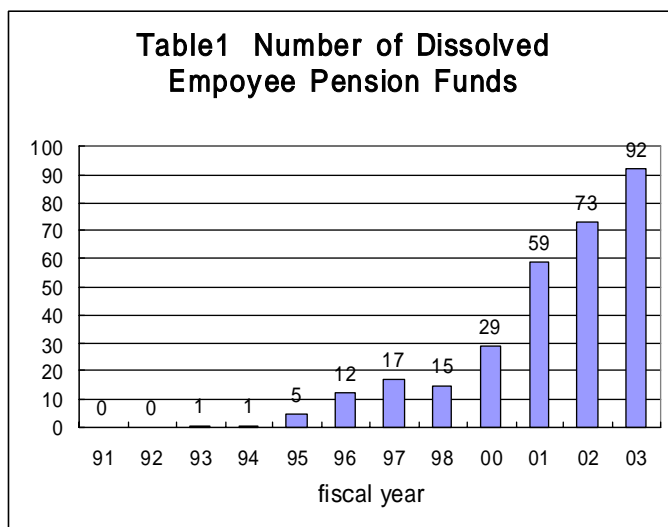
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The pension system reform law was enacted on June 5 when it passed the House of Councillors. While debates on the public pension system still continue boiling, problems related to corporate pensions have substantially subsided due to the enactment of the law and the recovery of stock prices since last year. Some employee pension funds reportedly want to put off returning the so-called “daiko” or substitute portion, that is the portion of pension assets they have managed on behalf of the government.

As recent pension-related developments, the number of dissolved employee pension funds increased to 92 in fiscal 2003, while that of funds allowed to return the substitute portion to the government reached 790 as of June this year.

According to book-closing reports by employee pension funds in fiscal 2002, assets were short of the amount of reserves required to cover the corporate pension component which accounted for more than half of all pension obligations on the average. In addition, 264 funds, or 15% of all funds, failed to keep the amount of assets needed to cover the substitute portion, while 63 funds were deemed financially unhealthy as their assets were below 90% of the reserves to cover the substitute portion (Note 1).

Although the number of employee pension funds with assets smaller than those needed to cover the substitute portion was said to decrease in fiscal 2003 thank to the recovery of stock prices, it is too early to conclude that the corporate pension system has pulled out of its critical situation in view of continuing moves to cut back on pension benefits.



Decrease In Demerits Of Substitute Portion

The pension system reform law includes a number of important changes for corporate pensions. One of them is the creation of elbowroom for the rate of exemption at which employee pension funds are exempted from payments to the government in return for managing a part of state-run employee pensions and pay out benefits on behalf of the government.

As the rate used to be fixed at 2.4% to 3.0% of the employees' annual compensation, payments by employee pension funds to the government were larger than exemptions if the average age of members of their pension plans was higher than that of the Employees' Pension Insurance run by the government. Now that the law has raised the upper limit on the exemption rate to 5.0%, employee pension funds are freed from the burden of additional contributions resulting from a disadvantageous age structure of their members. In other words, actuarial losses from the management of the substitute portion have been eliminated.

The method of calculating the minimum required reserves for the substitute portion has also been changed. As the new method applies a return on investment by the state pension system, sponsoring companies are no longer forced to shoulder additional financial burdens as long as their employee pension funds chalk up the same investment performance as the state.

In the past, employee pension funds incurred losses as a result of managing the substitute portion unless their return on investment was higher than 5.5%. As for fiscal 2004, funds are profitable if their return on investment was higher than 2.1%, which is the investment return for the public pension system in the previous year. Returns higher than the percentage were merits from the management of the substitute portion.

The number of employee pension funds increased in the past as the management of the substitute portion was beneficial to them. In particular, sponsoring companies could enrich pension benefits for employees with limited contributions when stock prices were high. But when stock prices drop for the third consecutive year in fiscal 2002, sponsoring companies faced huge financial burdens. Hearing their complaints about the financial burden, the government allowed them to return the substitute portion.

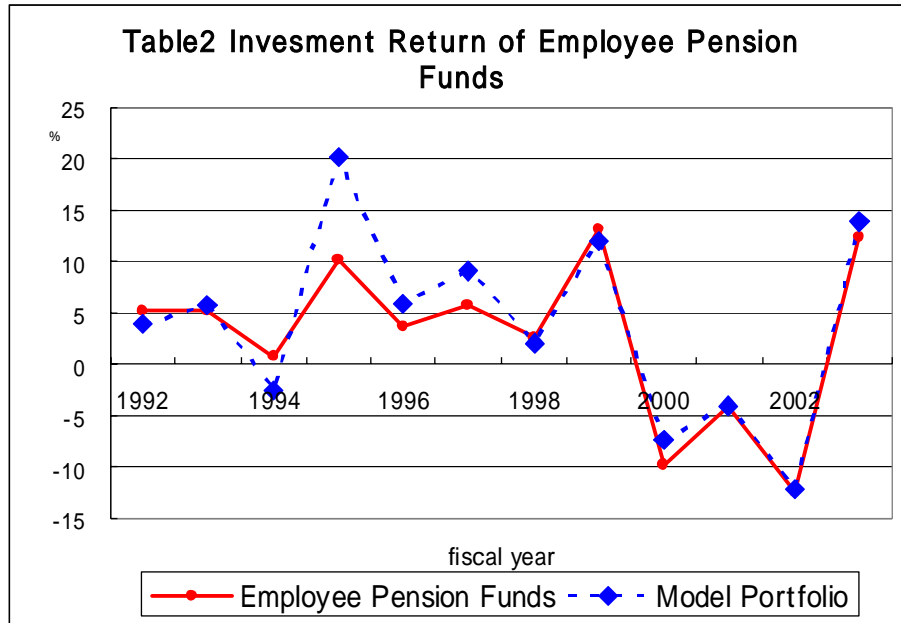
When viewed from corporate finances, the substitute portion is the same as borrowing funds from the state and investing them in securities for the allocation of returns to employees. The pension system reform law has lowered the borrowing rate from a fixed rate of 5.5% to a floating rate -- a return on investment by the state pension system.

Despite the floating rate, however, the essence of the substitute portion remains unchanged as borrowing interest-bearing funds for investment in risk assets. While there remains the question of whether companies should take such a risk, Toyota Motor Corp., Japan's most profitable company, returned the substitute portion to the government ahead of other companies possibly because of its concern about the question.

Management Of Assets Should Be Reinforced

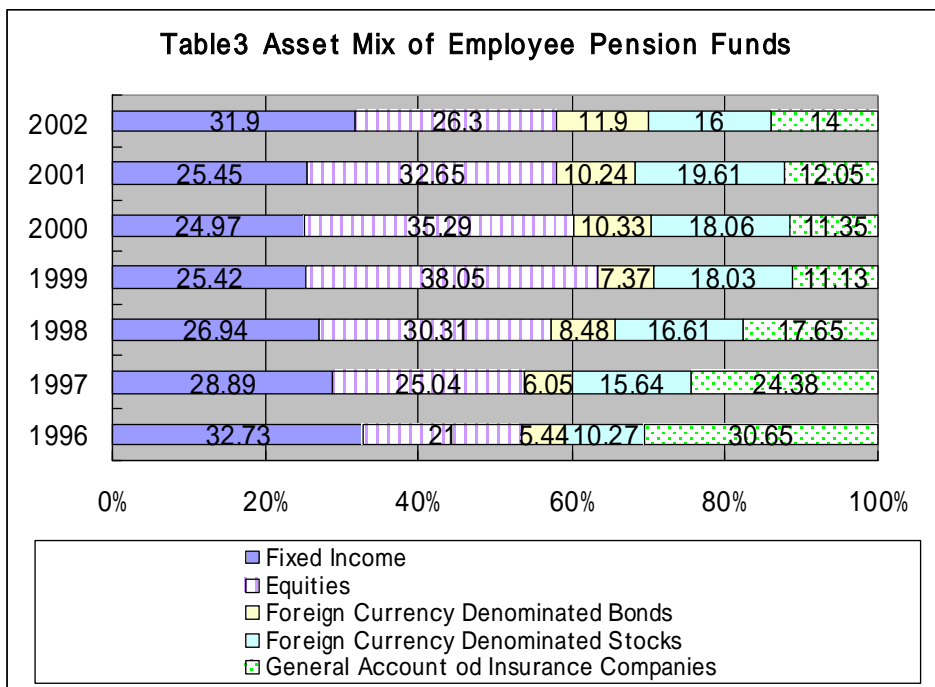
Let us consider again why a huge reserve shortage has taken place.

Table 2 shows a comparison between investment performance by all employee pension funds and that of funds presumed to invest in bond, stock and foreign-currency stock indexes at an asset allocation ratio of 5 to 3 to 2, which is referred to as a model portfolio in this essay (Note 2).



The performance of employee pension funds showed smaller fluctuations than the model portfolio until fiscal 1997, indicating that they took smaller risks until then. Starting in fiscal 1998, the fluctuations were similar or larger except in fiscal 2003. This means that employee pension funds took equal or larger risks than the standard portfolio.

Fiscal 1998 was the year when the government allowed employee pension funds to manage their assets fully on their own by removing its restriction on asset allocation ratios (Note 3). In other words, it was the first year when employee pension funds became responsible for asset allocations.



As shown by Table 3, the allocation of assets to life insurance companies for management plunged in fiscal 1999 because guaranteed yields on insurance policies began falling. In contrast, investment in domestic stocks and foreign-currency assets increased.

As a result, the ratio of domestic stocks and other assets, including convertible bonds, rose to 38.1% when the stock market became sluggish because of a financial crisis and deflation, pulling down investment performance by employee pension funds.

The poor investment performance of employee pension funds tends to be blamed on environment factors by using such expressions as stock price falls that take place once in 100 years. Actually, however, the unsuccessful allocation of assets was a key reason for it.

Why did such a situation take place? While many factors were pointed out, the biggest of them was probably employee pension funds' assumption of high targets for returns on investment.

The principle of investment by pension funds is to set a risk comfort level. In reality, however, many employee pension funds targeted high returns of more than 6% per annum due partly to an increase in costs caused by the construction of welfare facilities. Accordingly, they formed high-risk, high-return portfolios by increasing investment in stocks.

As another key reason, employee pension funds relied heavily on the framework of optimum asset allocations based on the capital asset pricing model (CAPM). In most cases, managers of employee pension funds are not professional investors and therefore formed long-term policy asset mixes by relying on the widely accepted optimum asset allocation model.

But the model maximizes errors if an expected return on investment is falsely assumed. By assuming expected returns and diversifications based on such factors as past averages, maximum returns can be secured with minimum risks only when there are no major structural changes and stock prices keep rising. Employee pension funds should have learned bitter lessons.

First of all, therefore, responsibility for management of assets must be clarified and actual management, such as decisions to allocate assets and change the allocation ratio, must be carried out as professional work.

Securities investment is a world where risks generate returns. Risks should be avoided when those involved in the investment are neither responsible for nor capable of management. Top priority should be given to the establishment of a pension management system that recognizes developments of the times such as shareholders' close scrutiny and calls for the transparency of management.

What is required by the times with regard to the latest pension system reform is to further clarify those aspects.

Reform Of Defined-Contribution Pension Plans Insufficient

Lastly, it should be pointed out that the latest reform has somewhat improved the portability of corporate pension plans. In addition, the upper limit on contributions to defined-contribution schemes has been raised to 46,000 yen per month from 36,000 yen for companies that do not have defined-benefit plans.

If employees contribute the maximum amount for 30 years and earn returns at an

annualized rate of 3%, they can receive 27.04 million when they retire. If the amount is managed to yield 1% annually, they can earn some 124,000 yen per month over the following 20 years.

But as it is uncertain whether such favorable investment results are possible, the amount of contributions may make a lot of people feel unsafe.

The pension system reform law has put off the introduction of contributions by employees. For 401(k) pension plans which are widely practiced defined-contribution schemes in the U.S., employees individually contributed dollars out of their pay to their account, which also receives company contributions for investment in order to prepare for their lives after retirement. Even if they quit the company to become self-employed or change jobs, they continue pouring money into their accounts under the scheme so as to accumulate enough assets through proper management until they retire.

Since mobility in the job market is expected to increase in Japan as well, needs for Japan to move toward a U.S.-style pension system will grow. People in Japan are expected to prefer a system under which they plan affluent post-retirement lives by combining a public pension system that guarantees minimum income with a corporate pension plan consisting of contributions by their employer and themselves.

Note 1: July 8, 2004, morning edition of the Nihon Keizai Shimbun

Note 2: Data presuppose annual rebalances but do not include their expenses. Indexes used to calculate returns on investment are TOPIX for stocks (dividends included), Nomura-BPI for bonds, and MSCI-Kokusai for overseas stocks (world other than Japan. Dividends included. Pretax basis. Denominated in yen). Results of fiscal 2003 are based on an estimate by R&I.

Note 3: Restriction before then was called a 5:3:3:2 rule requiring pension funds to have portfolios in which principal-guaranteed assets accounted for 50% or more of total assets, domestic stocks and foreign-currency assets each for 30% or less, and real estate for 20% or less.