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Characteristics and trend of severance and retirement benefits in Japan

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1. A brief History

- Development of the Lump-sum benefits
- Introduction of Tax Qualified Pension Plans
- Introduction of Employees' Pension Fund Schemes
- Structural Reform of Corporate Pension Schemes

Development of the Lump-sum benefits

- Fairly common by the early 20th century
- Favorable tax treatment for lump-sum benefits granted in 1952

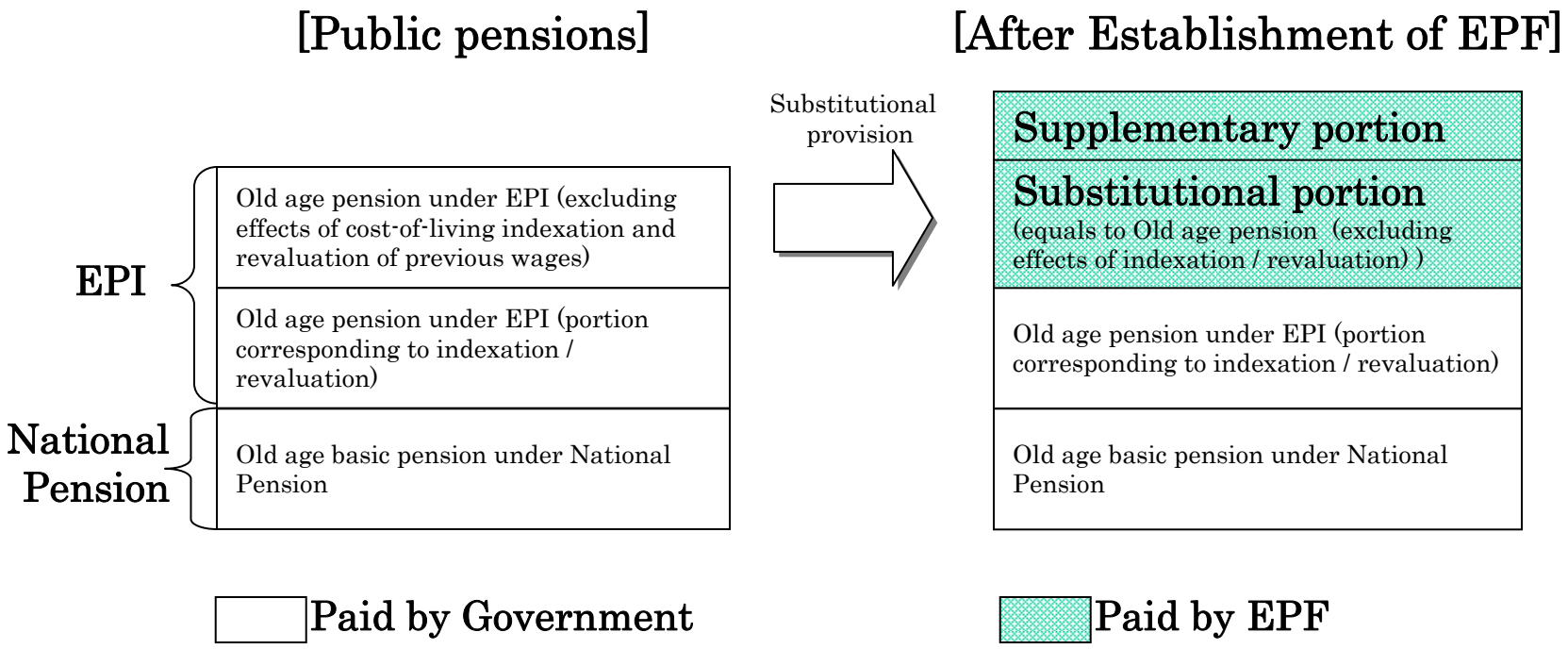
Tax Qualified Pension Plans (TQPPs)

- Tax reformation in 1962
  - Special treatment for DB type corporate pension plans
  - By adopting the TQPPs, many employers partly or wholly converted their book-reserved lump-sum benefits to funded pension benefits

Employees' Pension Fund (EPF)

- Employees' Pension Insurance (EPI)
  - public pension system for workers in private sector
- Amendment of the EPI in 1965
  - Introduction of Employees' Pension Fund (EPF)
- Modeled after the British system
  - Earnings-related old age pension benefits payable by the EPI
  - EPFs receive "exemption contribution"

Relationship between EPI and EPFs



Structural Reform of Corporate Pension Schemes

- June 2001
  - Defined Contribution Pension Act (DCPA)
  - Defined Benefit Corporate Pension Act (DBPA)
  - Amendment of EPI (Introduction of “Daiko-henjo”)

One of major purposes of the DBPA

- To protect employees' benefit rights

1. Funding requirements
2. Fiduciary responsibility
3. Reporting and disclosure requirements

Abolishment of the TQPPs

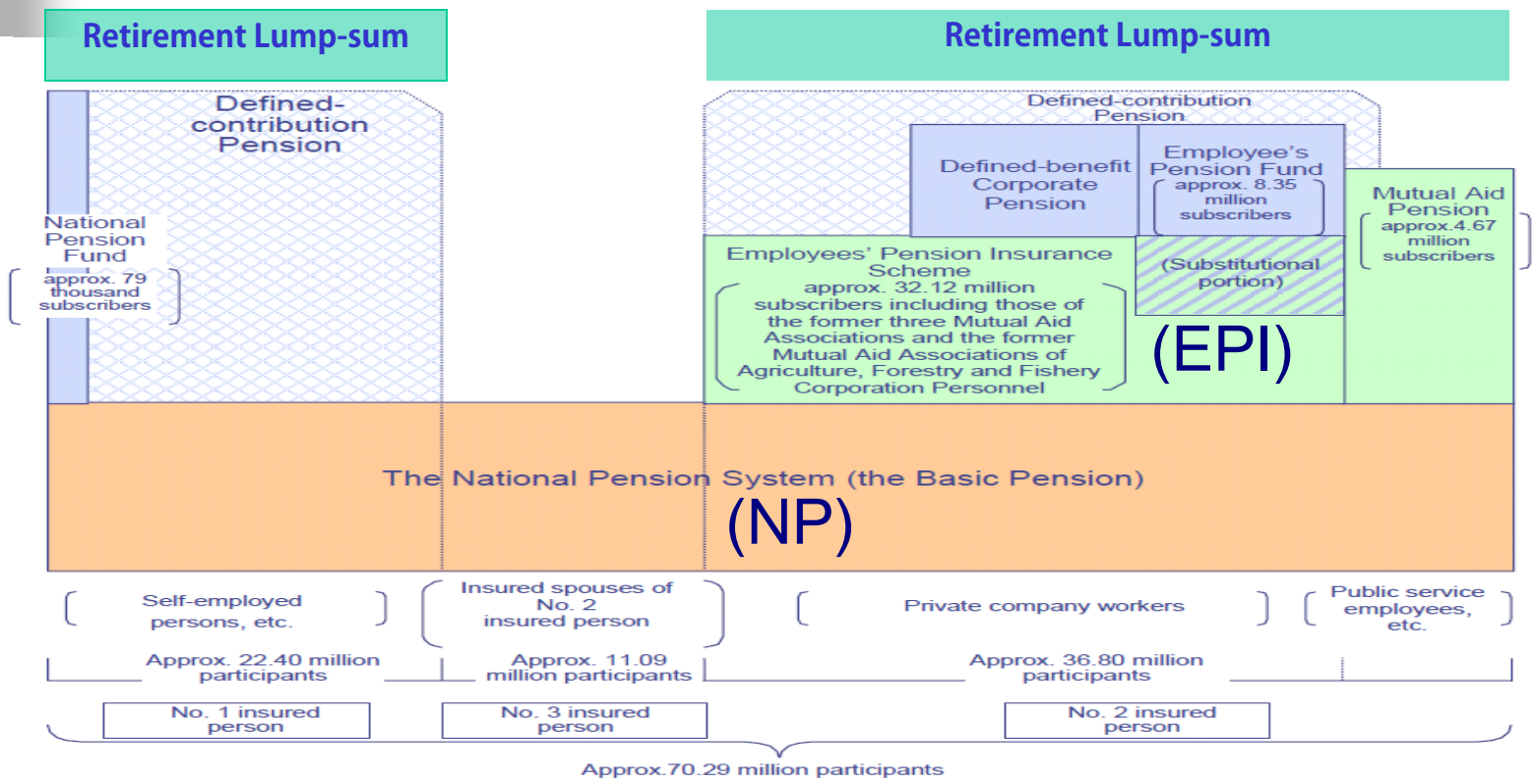
- Inadequate funding requirement compared to EPFs and DBCPPs
- Be abolished by March 31, 2012

“Daiko-henjo”

- An EPF separates the substitutional portion and transfers the obligation and related assets to the government (By the amendment of EPI)

- The remaining portion continues to exist as a DBCPP

Overview of the Retirement Benefits System in Japan



(As of 31 March, 2004)

2. Common benefit formulas

- An example of benefit formula for Lump-sum
- Pension amount of TQPP
- An example of EPF
- Cash Balance Plan
- Quasi Cash Balance Plan

An example of benefit formula for Lump-sum

Lump-sum amount

=Final monthly salary

×

The rate in the table specified according to the employee's length of service and reason for resignation

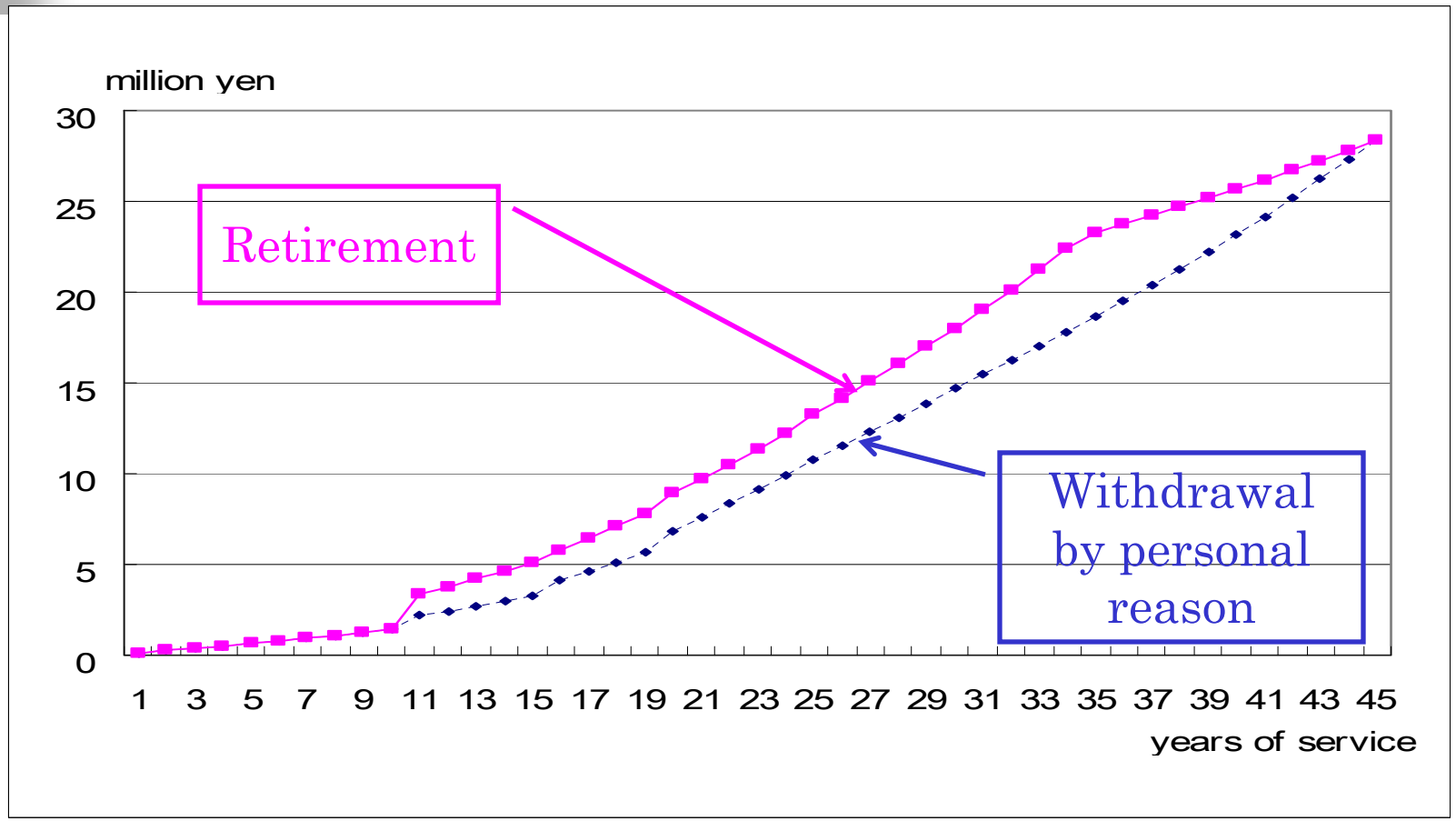
An example of rates for lump-sum

Rates are different according to the reason for resignation

Years of service	Reason for resignation	
	Withdrawal by Personal reason	Retirement
1	0.600	0.600
:	:	:
5	3.000	3.000
:	:	:
10	6.000	6.000
:	:	:
15	12.400	19.375
:	:	:
20	23.500	30.550

Years of service	Reason for resignation	
	Withdrawal by Personal reason	Retirement
25	33.500	41.340
:	:	:
30	41.500	50.700
:	:	:
35	47.500	59.280
:	:	:
40	53.500	59.280
:	:	:
45	59.280	59.280

An example of Severance and Retirement Lump-sum Amount



Pension amount of TQPP

- One of common pension benefits will be paid for 10 years
- Convert lump-sum into annuity
  - Equalize the present value of annuity with the lump-sum amount
  - Assumed interest for calculating present value is usually the same rate that is used to calculate the contribution rate ("conversion rate")

An example of benefit formula for pension by TQPP

Yearly pension amount

= Lump-sum amount

×

The rate in the table
specified according to the employee's age
at resignation

An example of rates for pension

Age	Rate	Age	Rate	Age	Rate	Age	Rate
35	0.496	42	0.341	49	0.235	56	0.162
36	0.470	43	0.324	50	0.223	57	0.153
37	0.446	44	0.307	51	0.211	58	0.145
38	0.423	45	0.291	52	0.200	59	0.138
39	0.401	46	0.276	53	0.190	60	0.131
40	0.380	47	0.261	54	0.180		
41	0.360	48	0.248	55	0.170		

Optional lump-sum benefit

- An employee can elect to receive a lump-sum payment equivalent to present value of pension in lieu of the annuity

From the employees' viewpoint

- The benefit at the resignation was not changed by the introduction of TQPP
- Change was only the preparation of payment by the company
  - ***internally book-reserved*** or
  - ***externally funded***

An example of EPF

- Substitutional portion
- Supplementary portion
  - Additional portion
    (major part of supplementary portion)
    - Similar to TQPP
    - Pension benefits are required to be paid for life
    - Present value of the pension benefits for guaranteed period is usually equivalent to the amount of converted lump-sum

Cash Balance Plan (CBP)

- Permitted only for EPFs and DBCPPs
  - Conversion rate from a lump-sum benefit to a pension benefit can vary according to the move of government bond rate, even after the commencement of annuity without beneficiary's consent
- Not allowed for TQPPs

Quasi Cash Balance Plan (QCBP)

- Permitted for EPFs and DBCPPs, by deregulation in May 2003
  - Lump-sum amount for employee is calculated by traditional pattern
  - Pension amount alters according to market without beneficiary's consent

3. Trend of benefit systems

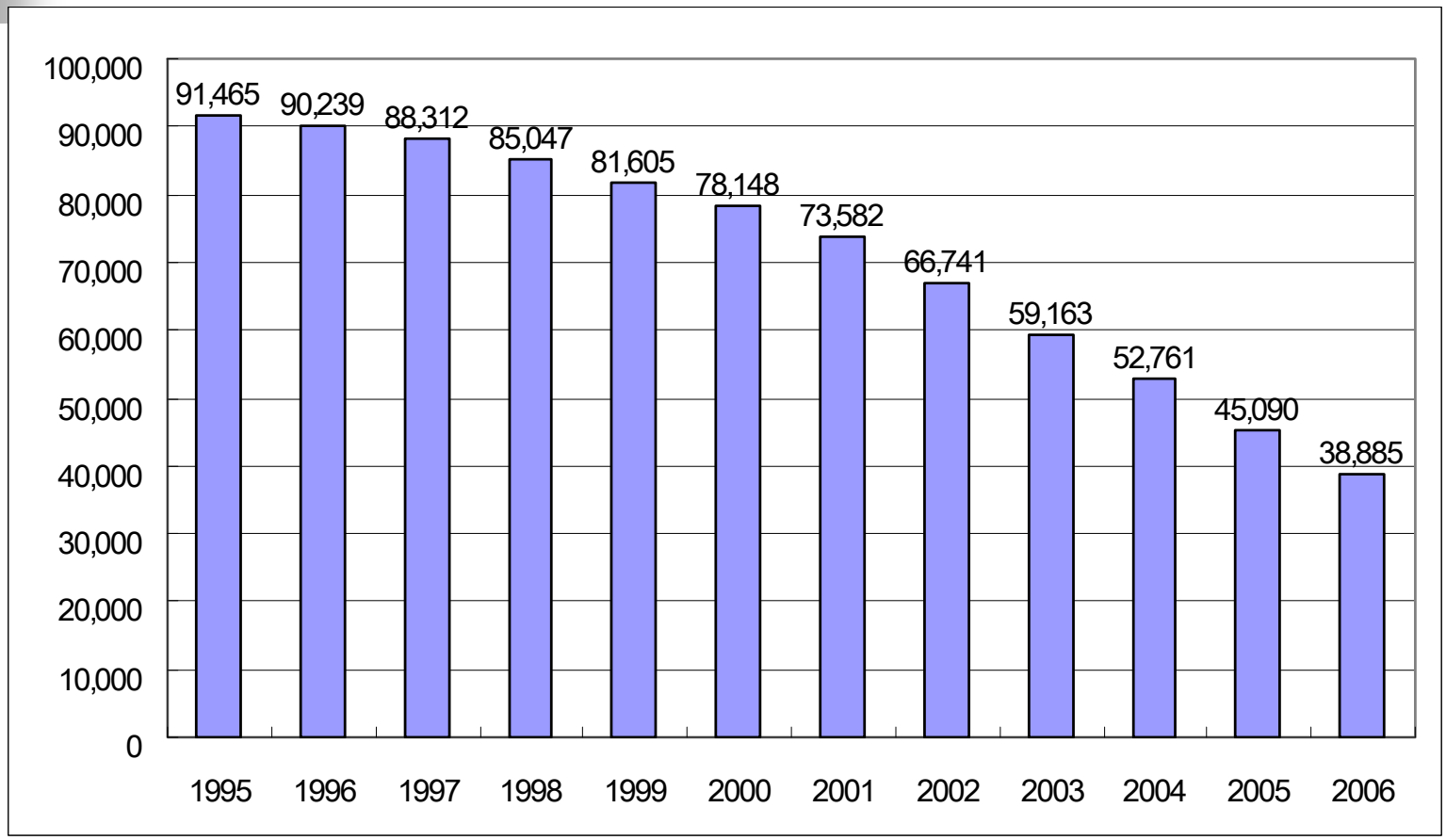
- Some statistics*
- Efforts to continue DB type plans
- An Example of adoption of DC plan

*Sources:

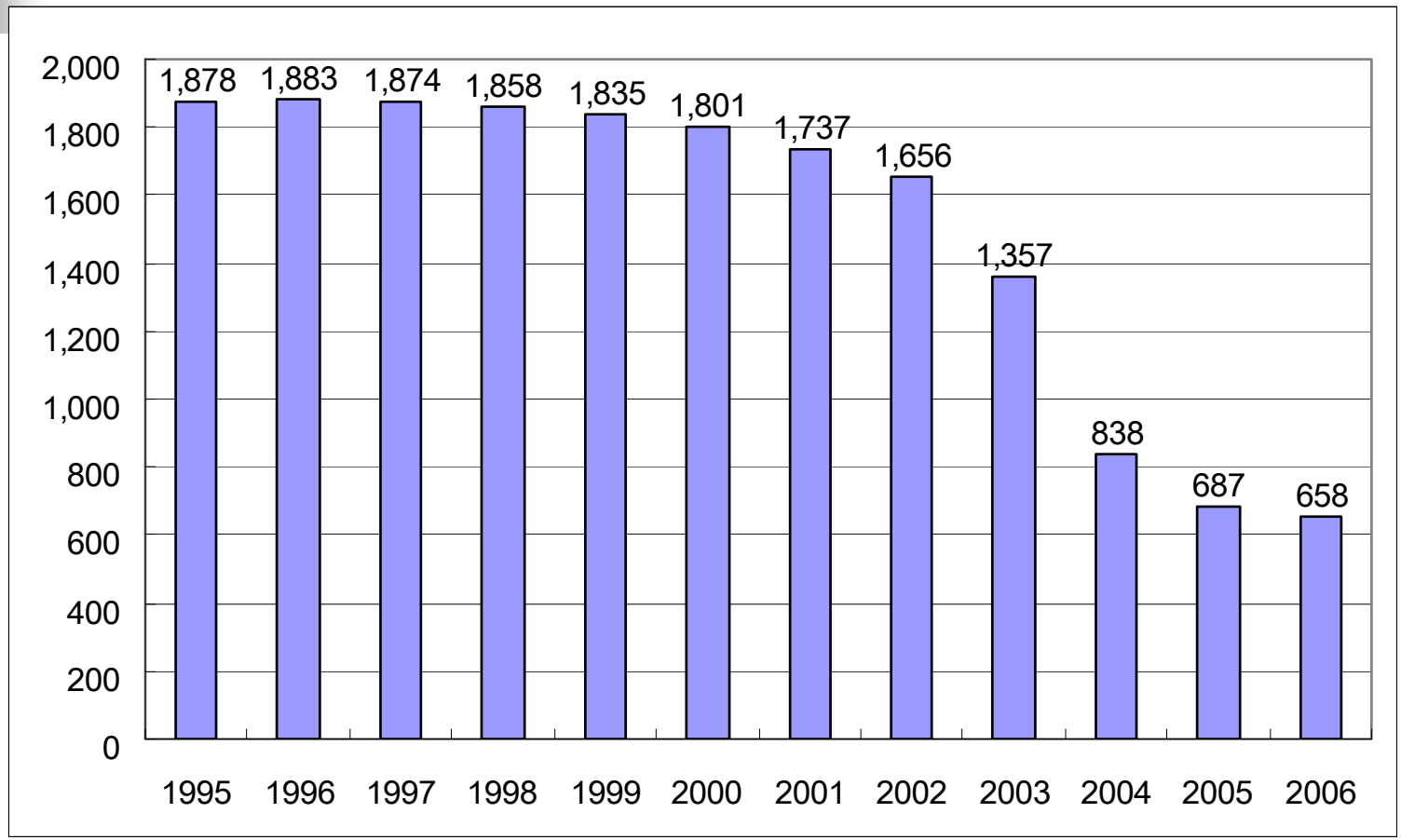
Pension Fund Association, [2007] “Kigyou Nenkin ni kansuru Kisoshiryou” (in Japanese)

Ministry of Health, Labor and Welfare home page

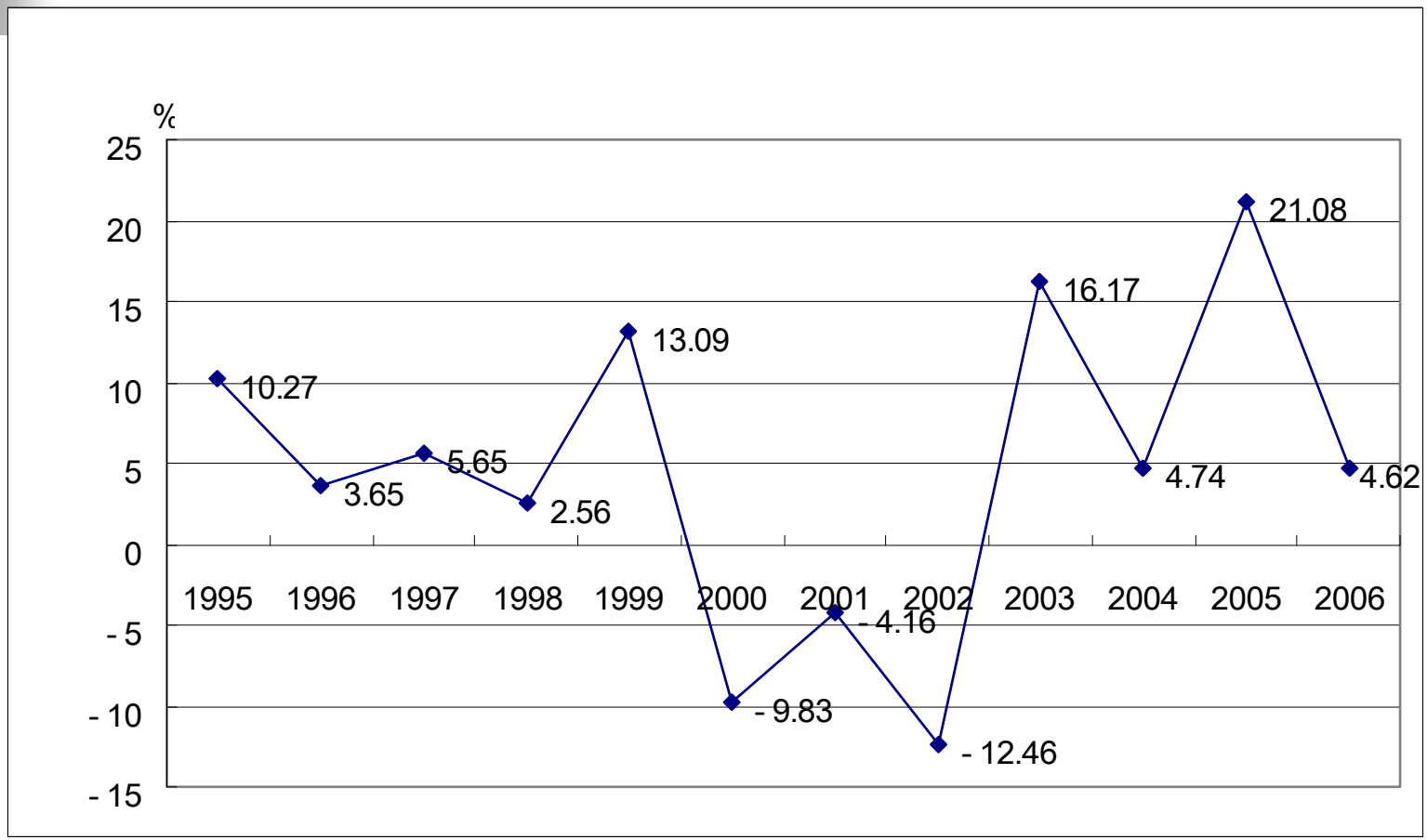
Change in the number of TQPPs



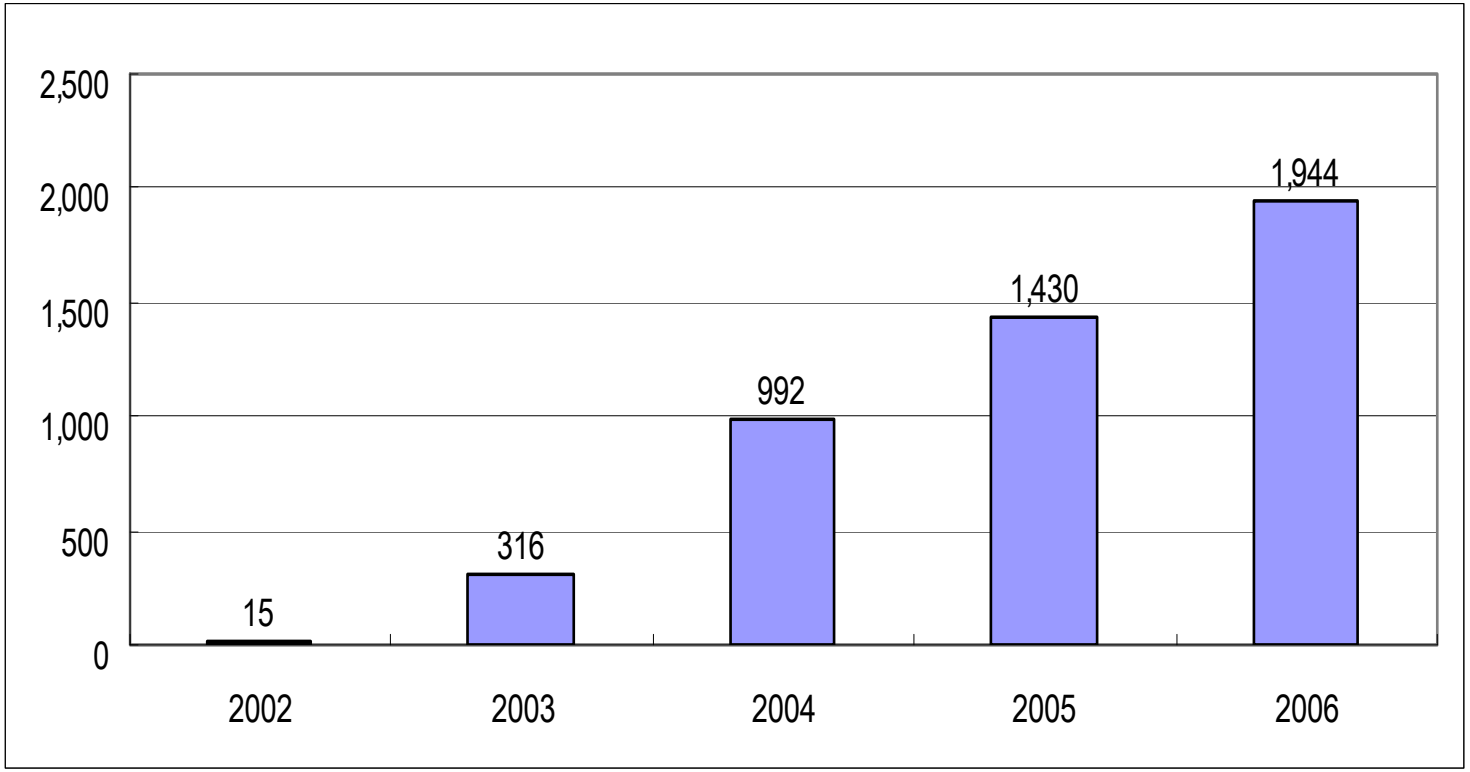
Change in the number of EPFs



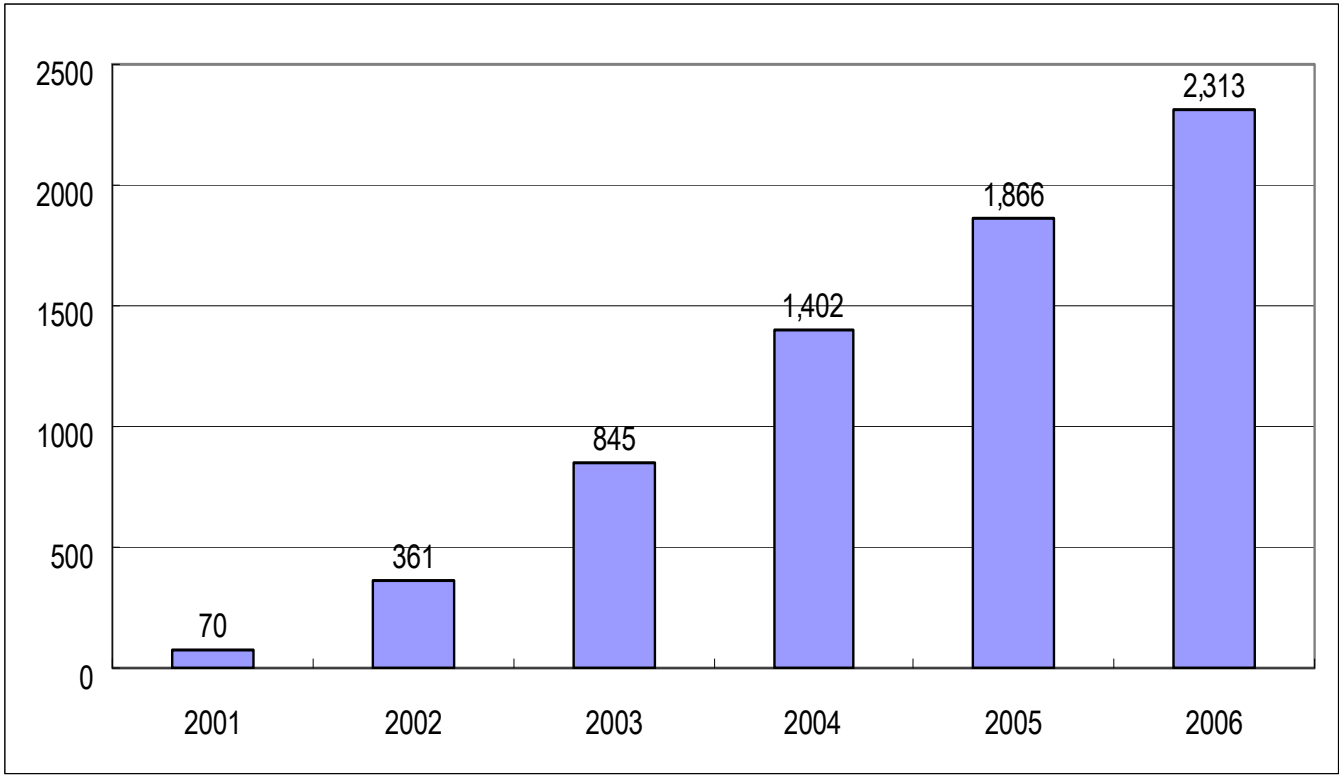
Rates of Return on Investment of Assets (EPFs)



Change in the number of DBCPPs



Change in the number of DC plans



Assets held by the Plans

(In Trillion Yen)

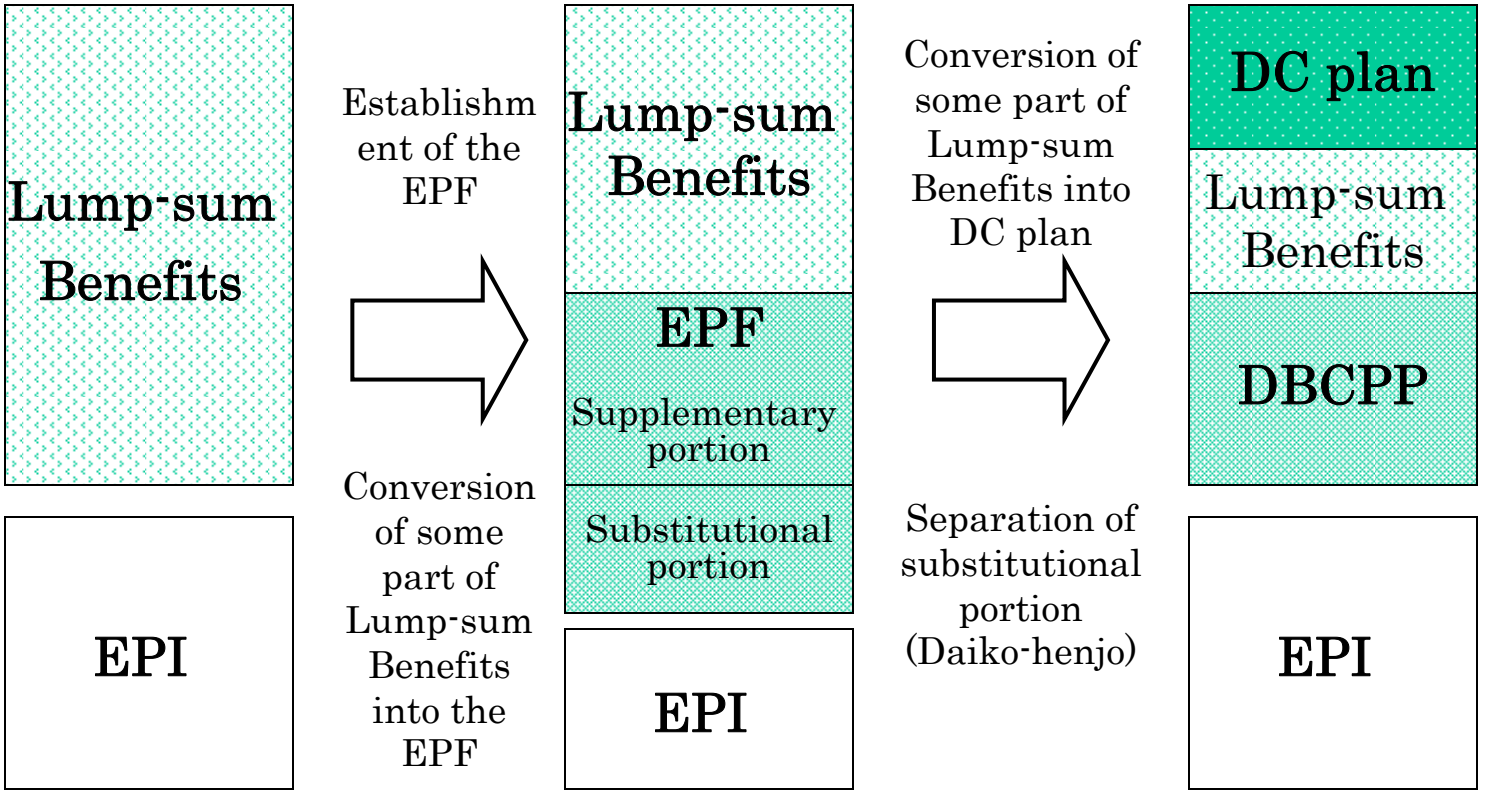
Type of plans	Amount	Date of survey
TQPPs	17.3	March, 2006
EPFs	24.7	March, 2006
DBCPPs	22.1	August 2005 – July 2006
DC plans	2.2	March 2006

Small share compared to DB type plans

Efforts to continue DB type plans

- Many employers want to reduce their pension liabilities
- Examples to lessen liabilities while maintaining DB plans
  - Reduction of the conversion rate
  - Reduction of benefit period

An Example of adoption of DC plan



4. Accounting standards for post-employment benefits

- Some issues of Japanese GAAP
- Upcoming new standard by IASB*
- International convergence

*Sources: IASB home page

Some issues of Japanese GAAP

- Big issues in the treatment for the substitutional portions of EPFs
  - Calculation of Benefit Obligations
  - Treatment of subsidies

Benefit Obligations

- An EPF does not have any obligation for substitutional portion that exceeds its Minimum Actuarial Liability (MAL)
- But the obligation for substitutional portion is calculated by Projected Unit Credit method
- PBO for the substitutional portion is usually greater than MAL

Subsidy #1

- An EPF receives subsidies from EPI when it pays substitutional pension
- In calculation of PBO for substitutional portion, these subsidies ***are exempted from the benefit***

Subsidy #2

- An EPF will receive subsidies from EPI when the financial condition of the substitutional portion becomes bad
- In calculation of PBO for substitutional portion, these subsidies ***are <u>not</u> exempted from the benefit (but deducted from the post-retirement costs)***

Incorrectness

- Money of same meaning to an employer should be treated in an identical way
- But two types of subsidies are treated differently

The opinion by the JSCPA

- The substitutional portions should not be included in the calculation of PBO
- Assets equal to MAL should be subtracted from pension assets

Upcoming new standard by IASB

- IASB project
  - To issue an interim standard in 2011
- Discussion Paper
  - To be published by the end of the first quarter of 2008

Presentation for DB costs by IASB Approach 1

All changes in the defined benefit obligation and in the value of plan assets are presented in profit or loss in the period in which they are incurred.

Presentation for DB costs by IASB Approach 2

The costs of service are presented in profit or loss. All other costs are reported as consequences of deferring payment of employee remuneration.

Presentation for DB costs by IASB Approach 3

The changes that arise from remeasurements relating to financial assumptions are presented outside profit or loss. Remeasurements relating to financial assumptions arise from changes in the discount rate and in the value of the plan assets. Changes in the amount of post-employment benefit cost other than those arising from remeasurements relating to financial assumptions, eg the costs of service, interest cost and interest income, would be recognised in profit or loss.

Presentation for DB costs by IASB

Approach	Costs presented in profit or loss	Costs presented outside profit or loss
1	• All	• None
2	• Service costs • Actuarial gains and losses on the defined benefit obligation except those arising from changes in the discount rate	• Interest cost • Actuarial gains and losses arising from changes in the discount rate • All changes in plan assets
3	• Service cost • Interest cost • Actuarial gains and losses on the defined benefit obligation except those arising from changes in the discount rate • Imputed interest income on plan assets determined using the discount rate determined by reference to market yields at the balance sheet date on high quality corporate bonds	• Actuarial gains and losses arising from changes in the discount rate • Changes in the fair value of plan assets other than those included in profit or loss

International convergence

- Convergence of accounting standards by the Accounting Standards Board of Japan (ASBJ) and IASB is in progress

- Possibility of the immediate recognition of *all changes* in profit or loss in Japanese GAAP

The side effect of convergence

Risks of enormous fluctuations in their profit or loss

In order to avoid such risks

Many Japanese employers may give up their DB type plans

5. Concluding remarks

- In Japan, traditional DB plans have worked very well to support post-retirement life

Efforts to maintain DB

- When DC and hybrid plans were introduced in the beginning of this century, many people said that almost all of DB plans would be changed to new plans
- But many companies have made enormous efforts not to change DB type plans
- And it seems they would like to maintain the same structure in the future

Influence of accounting standards

- The accounting standards have tremendous influence on post-employment benefits
- The Japanese accounting standard for post-employment benefits was a one of major causes that tempted many employers to change their EPFs into DBCPPs

Immediate recognition of actuarial gains and losses

- If the immediate recognition in profit or loss for actuarial gains and losses is required in the future, that change may cause many employers to give up their efforts to maintain their DB plans
- And in that case, it may lead to very big issues for both employers and employees

To avoid big risks for fluctuation

- Fluctuation of return on assets can not be avoided
- Fluctuation of benefit obligation may be managed by a new measurement

One possible new obligation

- The obligation for an employee's lump-sum benefits can be
  - –The amount that would be paid to him/her if he/she quits on the measurement date

In Japanese such amount is called "Yo-Shikyuugaku"

“Yo-Shikyuugaku” is not omnipotent

- “Yo-Shikyuugaku” can not handle pensions for life in the same way
- More detailed discussion will be needed

- Great attention to actuaries in that discussion

Thank you

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