

Pensions, Benefits and Social Security Section (PBSS)
Atelier n° 25

AIJ Scandal and the Future of Occupational Pensions in Japan

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AIJ Scandal and the Future of Occupational Pensions in Japan

Authored by the former manager of AIJ
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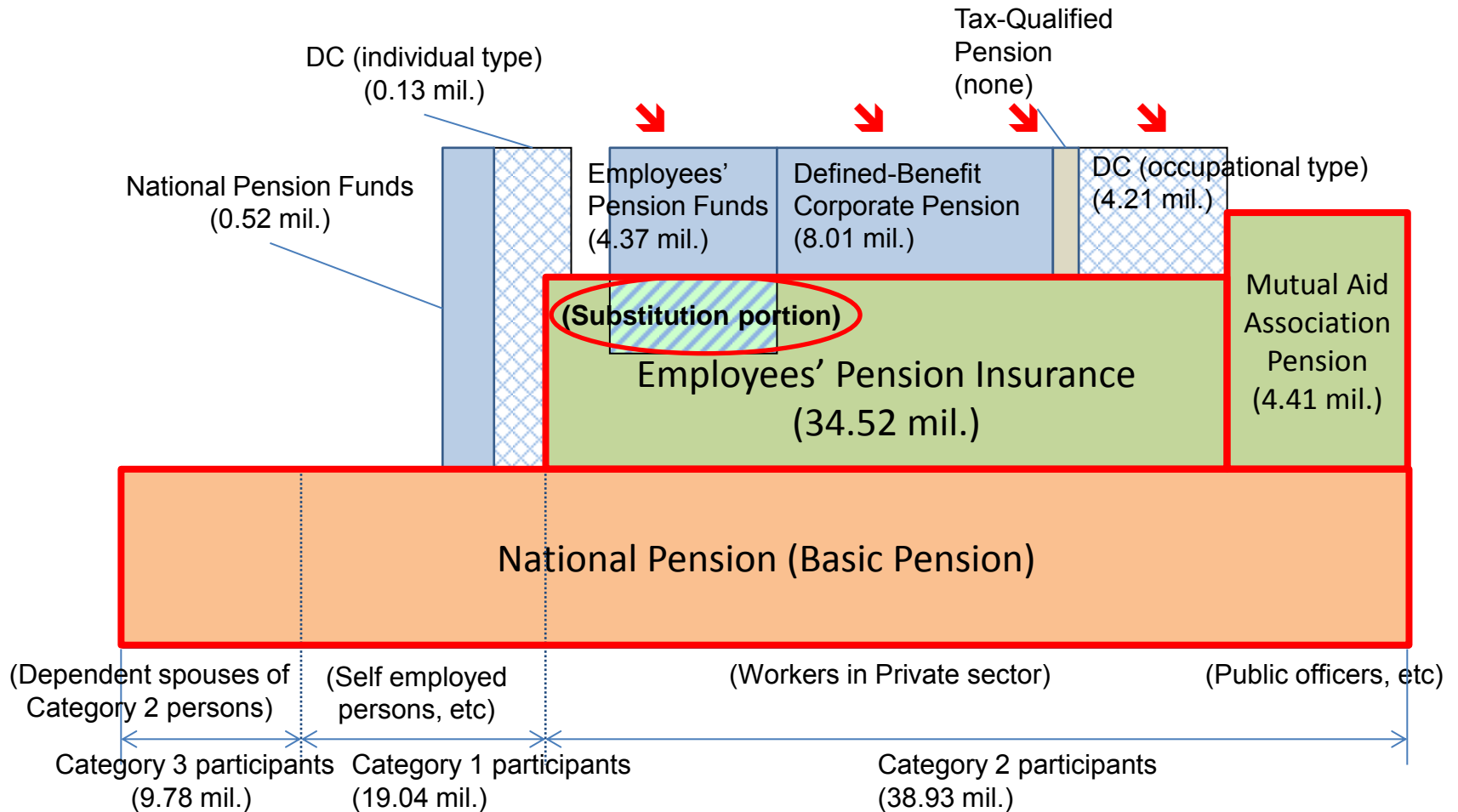
Kazuhiko Asakawa
President of AIJ

AIJ Scandal and the Future of Occupational Pensions in Japan

- 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

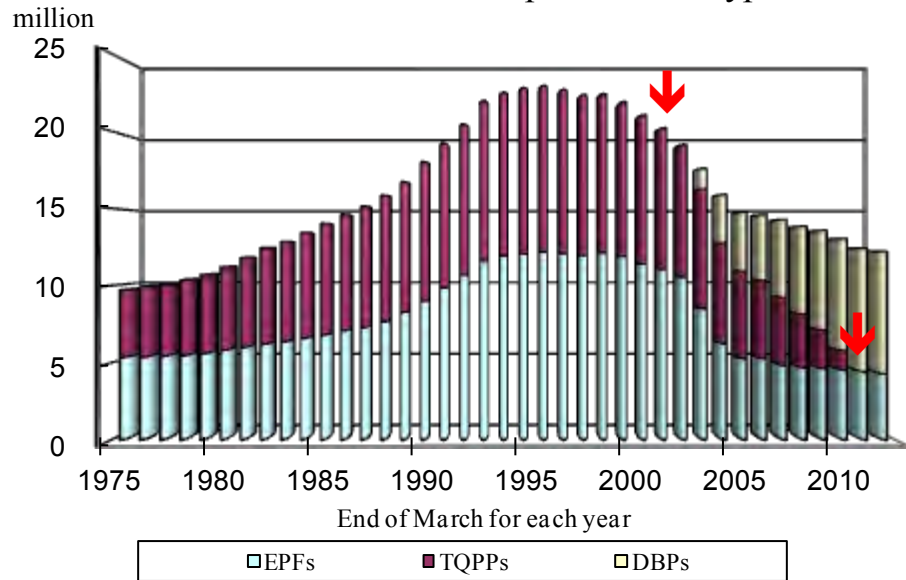
Pension system in Japan

(Number of active participants as of March, 2012)

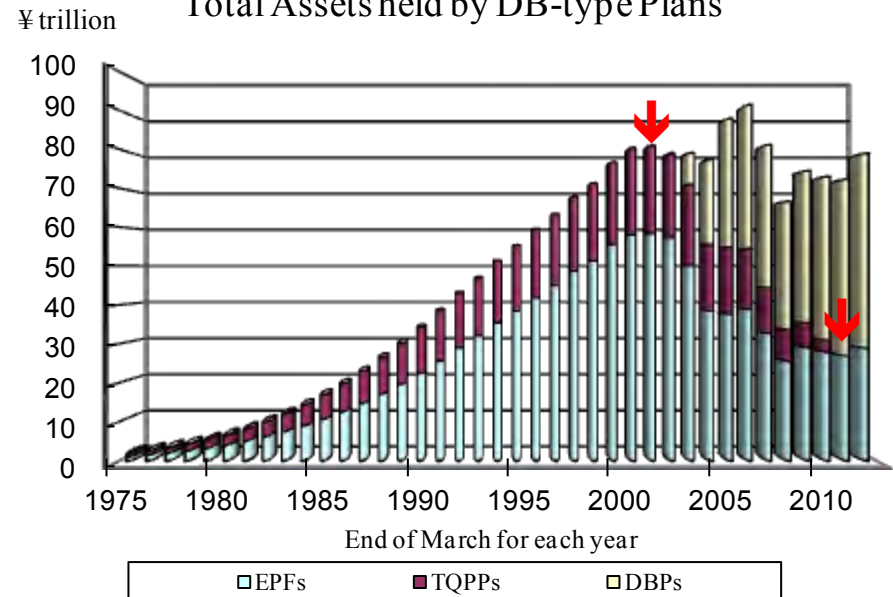


Development of DB-type Pensions

Number of Active Participants in DB-type Plans



Total Assets held by DB-type Plans

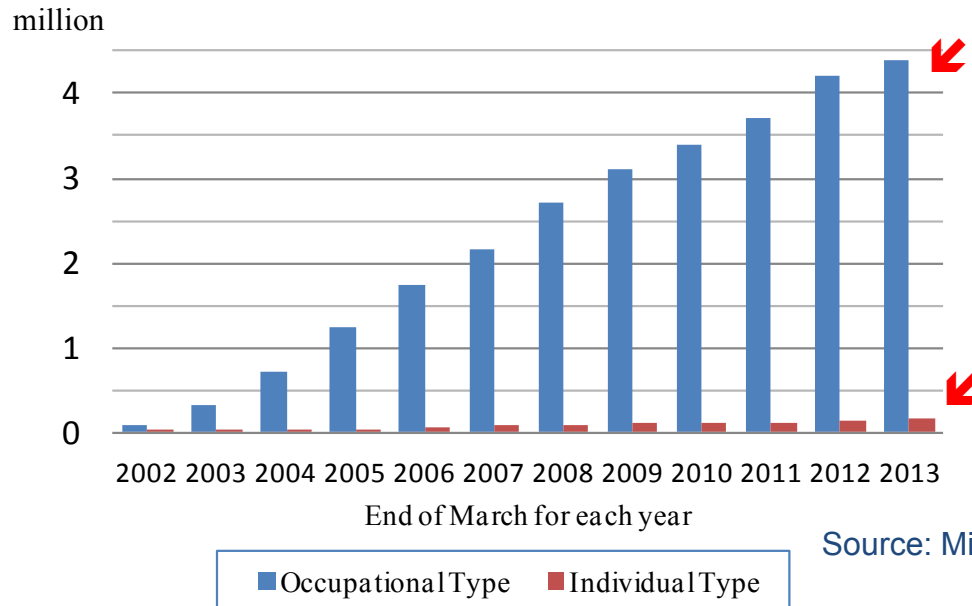


Source: Trust Companies Association of Japan

- ✓ DB corporate pension law was introduced in 2001 and became effective in 2002.
- ✓ The tax preferable status of TQPPs was expired at the end of March 2012.
- ✓ EPF can be converted to a plan of other type, such as DBP, by transferring its substituted benefit obligations and corresponding assets to the government.

Development of DC Pensions

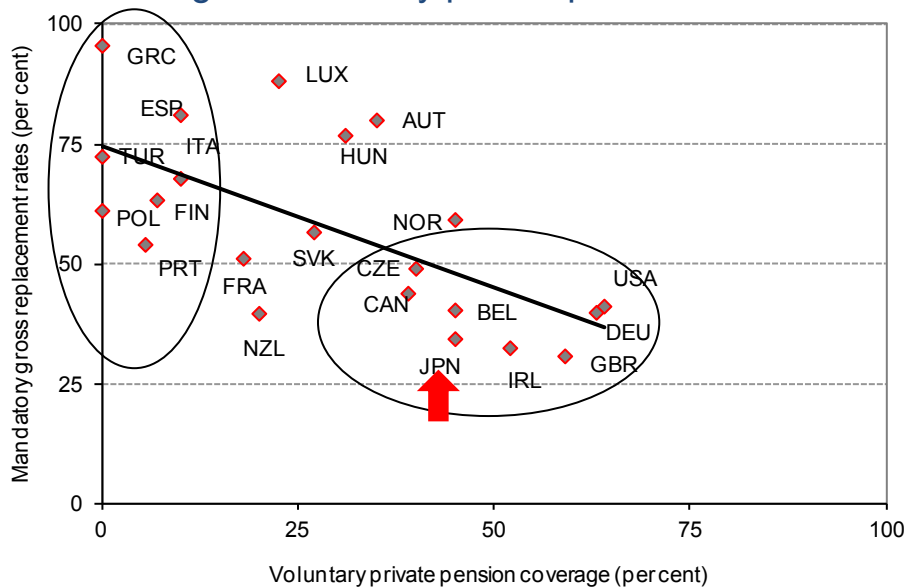
Number of Active Participants in DC Plans



- ✓ DC pension law was introduced in 2001.
- ✓ While the number of active participants for “occupational type” plans has been growing steadily, the number for “individual type” plan is still negligible.
- ✓ The total asset for occupational type plans as of the end of March, 2013 was about \ 6.8 trillion.

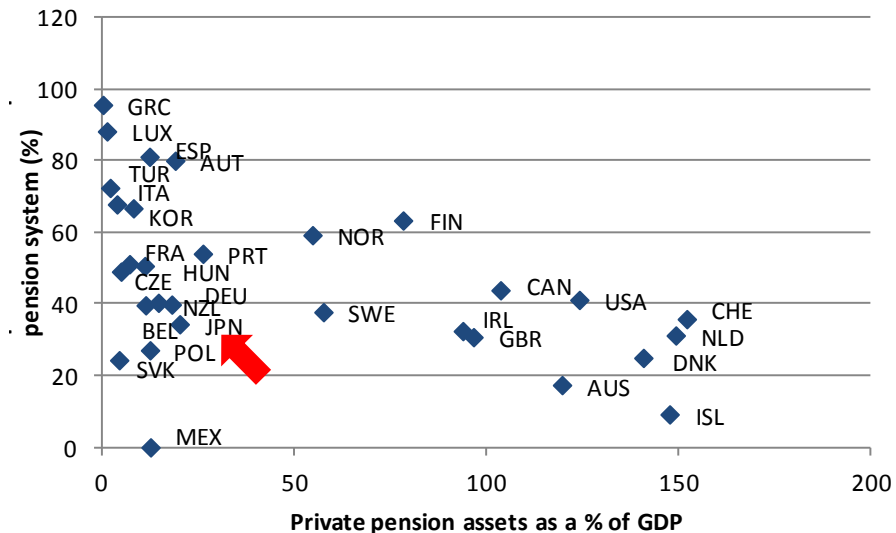
Current Position in Global Comparison

Average projected mandatory pension and coverage of voluntary private pensions



Source: Pensions at a Glance: Public Policies across OECD Countries 2007 Edition - OECD © 2007

Private pension assets compared with the public pension system's gross replacement rate, 2007



Source: OECD Private Pensions Outlook 2008 - OECD © 2009

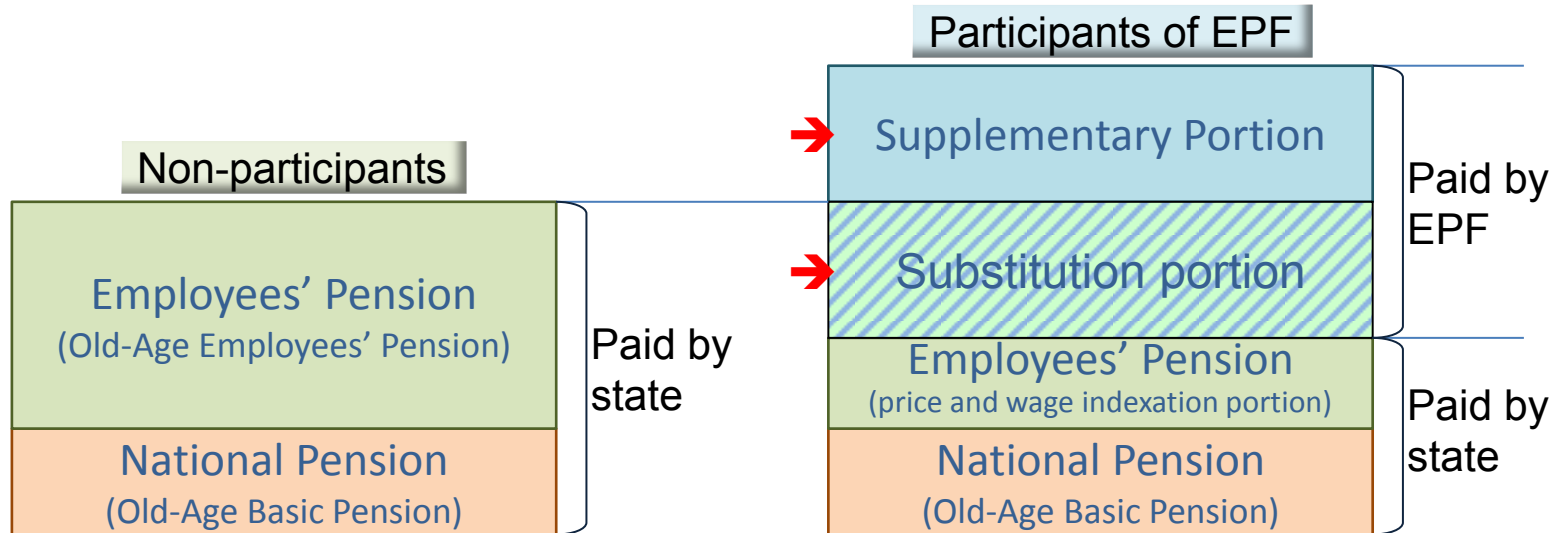
- ✓ Although the coverage ratio for Japan is based on only external funding schemes, it is somewhat lower than those of counterparts.
- ✓ The total assets of private pension plans in Japan account for only 20% of GDP, while the ratios of UK, Ireland and USA are around 100% or more.

Introduction of EPF system

- ✓ EPF was introduced by the reform of the Employees' Pension Insurance (EPI) 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, business communities, such as Japan Economic Federation, argued that they could not support the benefit hike policy without adjusting the lump-sum schemes.
- ✓ On the other hand, labor unions opposed the adjustment 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.
- ✓ 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.

Outline of EPF scheme

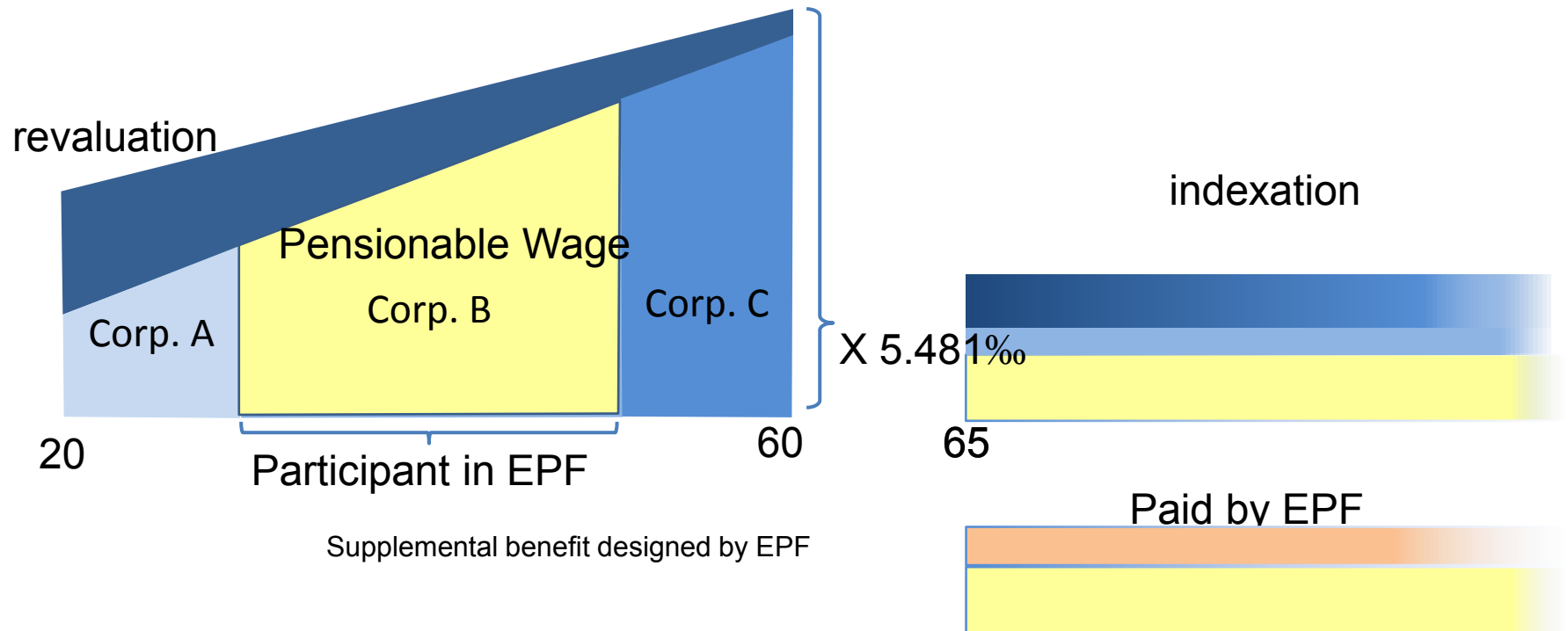
Structure of EPF Benefits



- ✓ EPFs substitute part of Old-Age Employees' Pension (earning related portion excluding the indexation) and pay their own supplementary benefits.
- ✓ Employer who provides EPF and its employees are exempted from paying part of contributions to EPI in return for the substitution (exempt premium).
- ✓ Funding standards for Supplementary portion are based on normal actuarial cost methods, while financial structure of Substitution portion is quite unique.

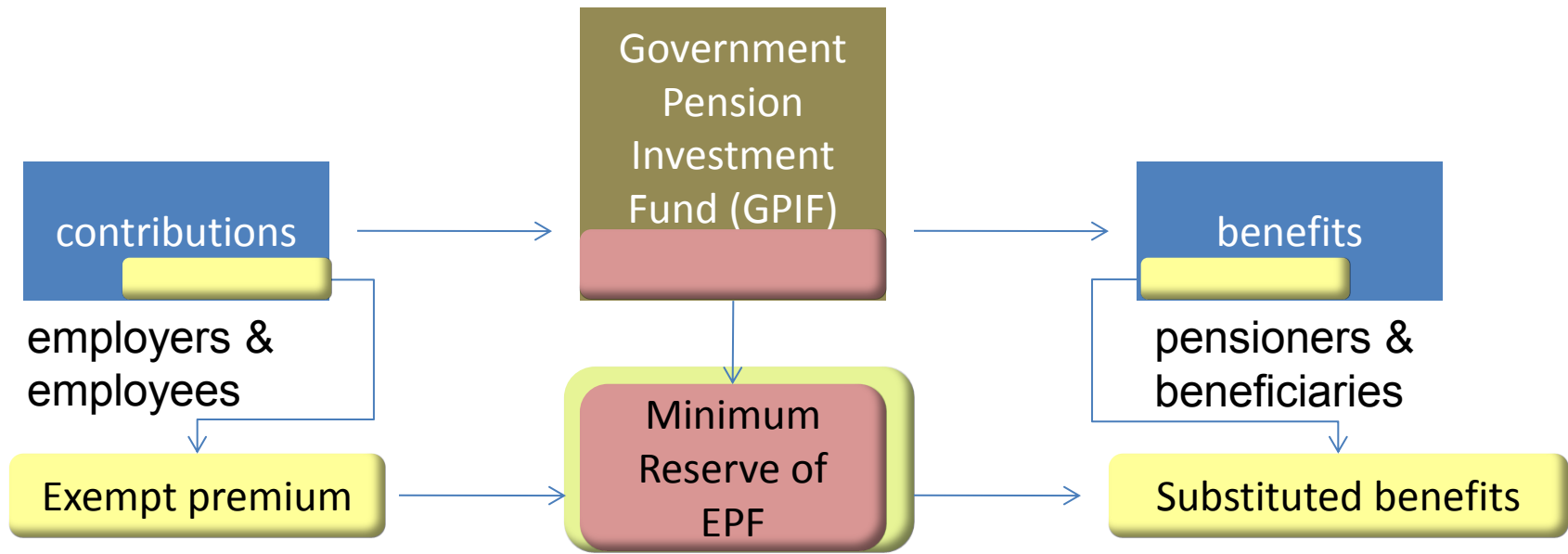
Historical background and Outline of EPF scheme ⁹

Substitution of Old-age Employees' Pension



- ✓ EPFs substitute only Old-age pension benefits in EPI (no survivors' and disability benefits).
- ✓ EPFs do not substitute the part of benefits related to wage revaluation and indexation.

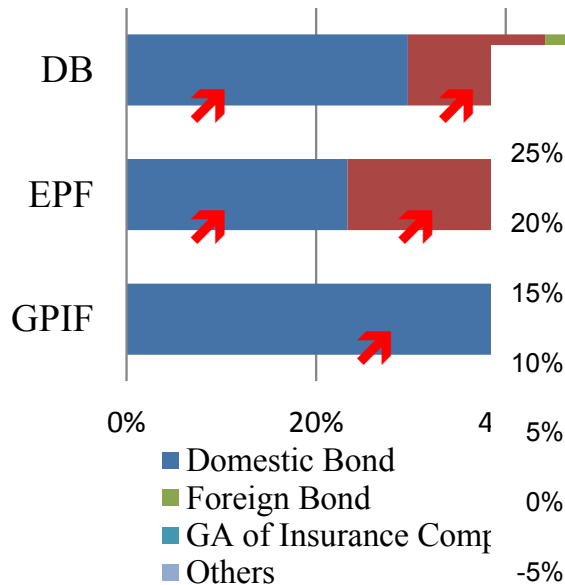
Financial neutralization and Minimum Reserve



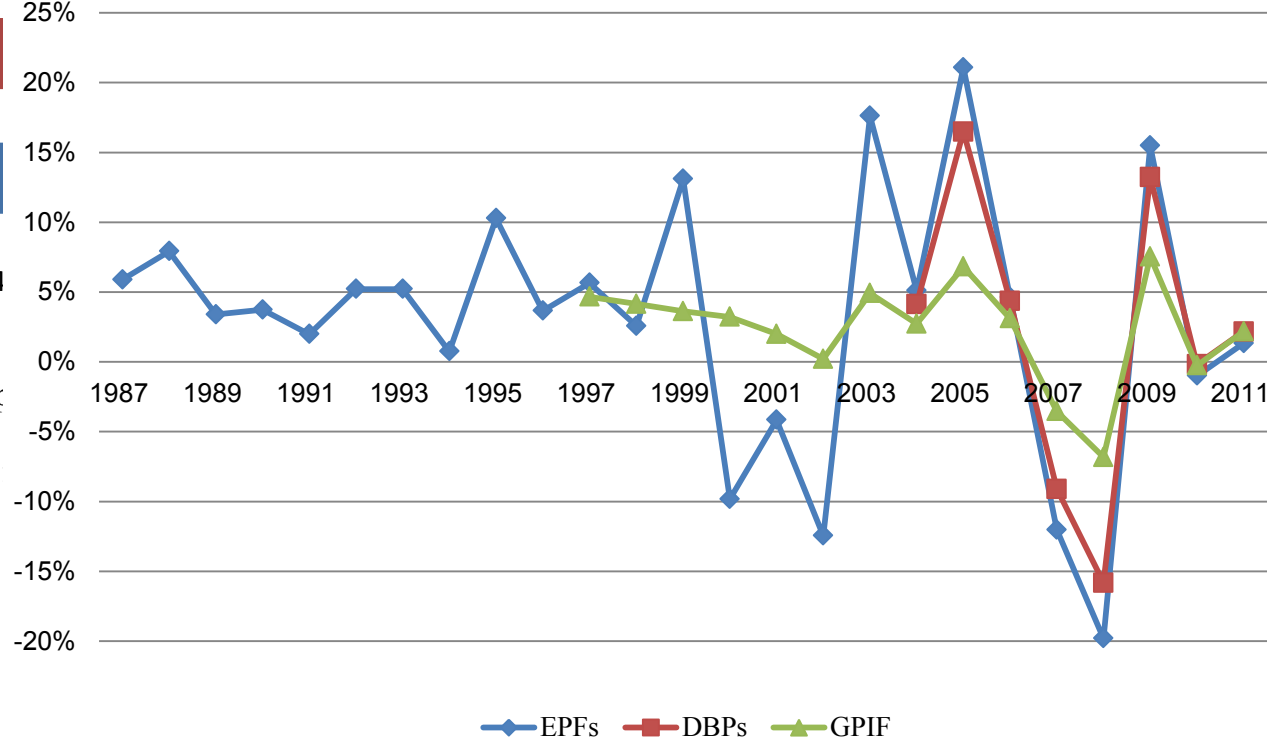
- ✓ EPF accumulates exempt premiums, manages the fund, and pays substituted benefits.
- ✓ Minimum Reserve (MR) of EPF is calculated using exempt premiums, substituted benefits and investment performances of GPIF, that is, MR is the amount calculated retrospectively assuming that the exempt premiums were managed by GPIF.
- ✓ EPF has to make up the funding shortage to MR (if any), which is mainly caused by its investment strategy different from that of GPIF.

Asset Mix and Historical Performances

Asset Mix for Each Plan Type



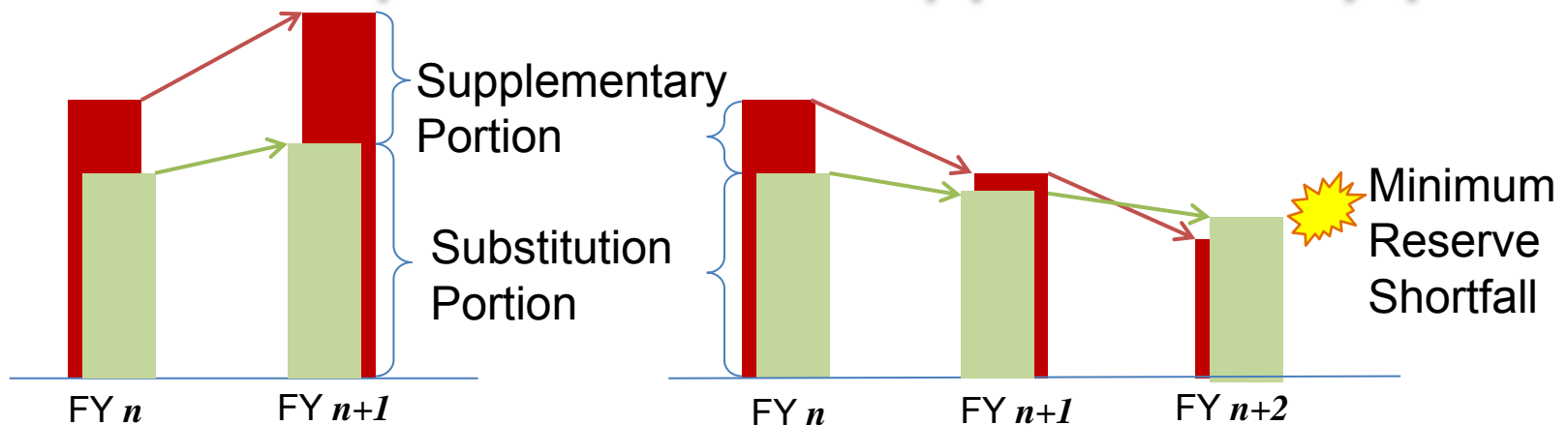
Historical Investment Performances



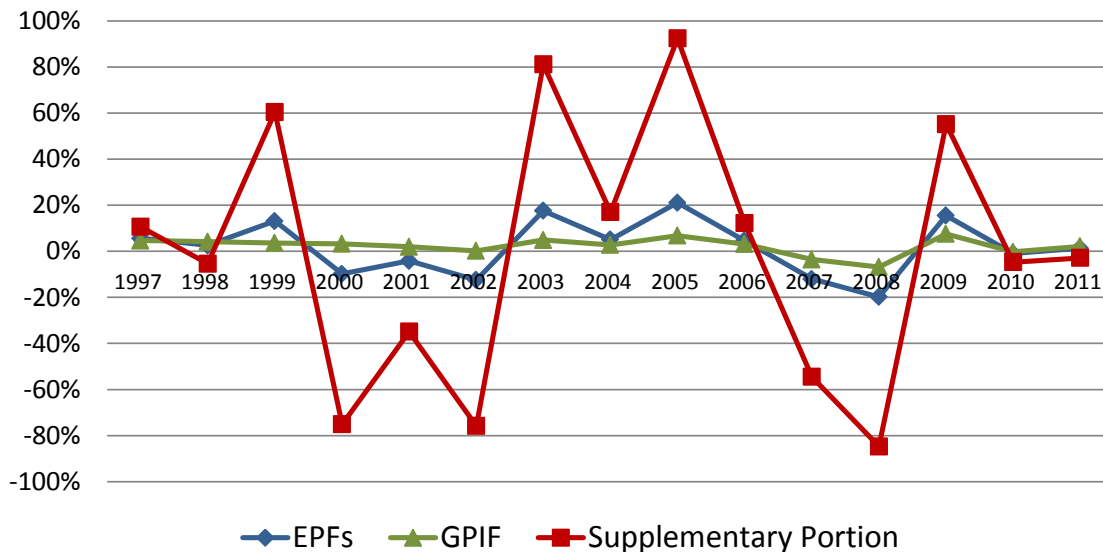
Source: Pension Fund Association FY 20

Source: Pension Fund Association, Government Pension Investment Fund (GPIF)

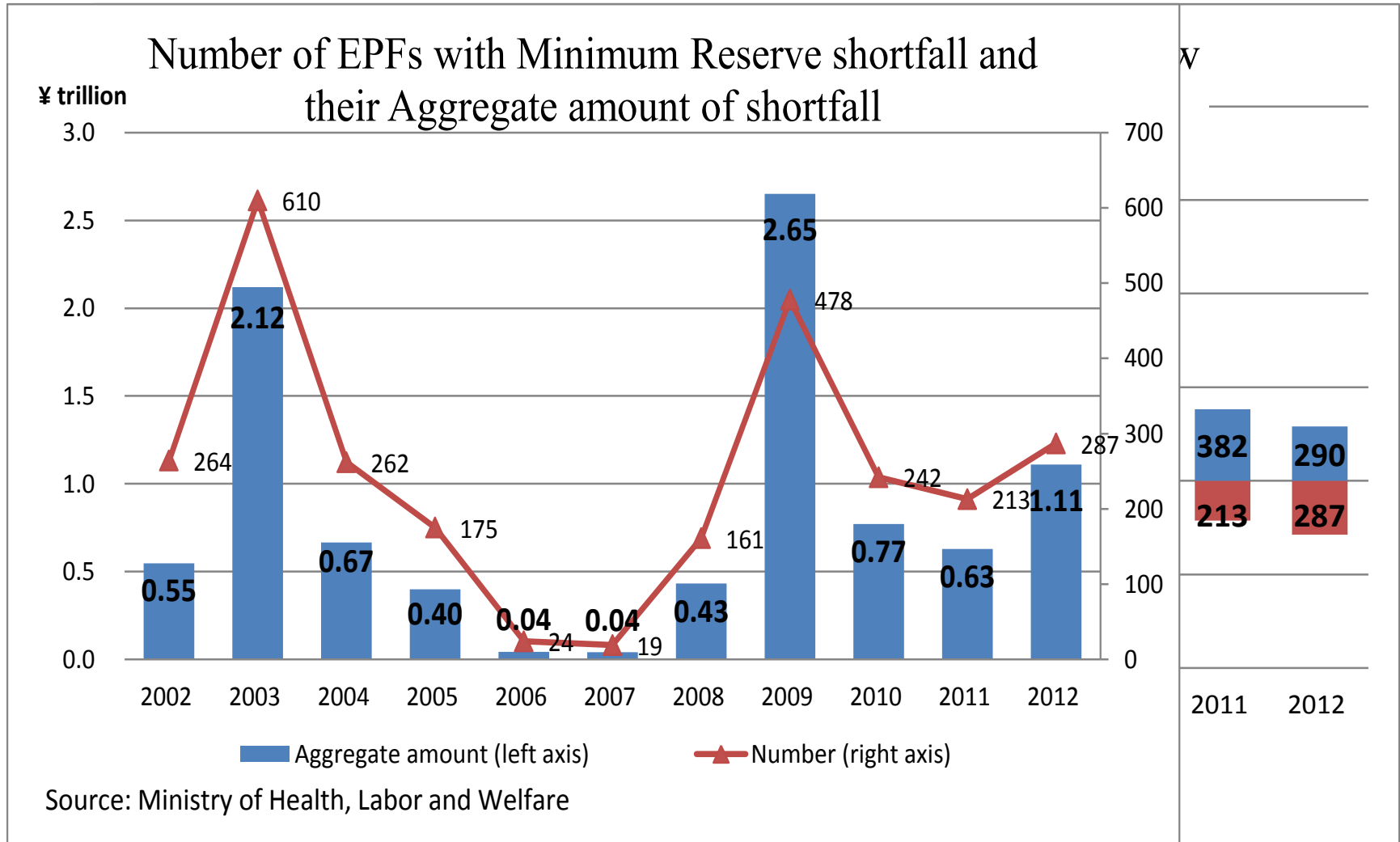
Financial Implication for Supplementary portion



Leverage Effect in Supplementary Portion
 Assuming that Assets deemed to be 120% of Minimum Reserve at the beginning of each fiscal year



Minimum Reserve Shortfall



Outline of AIJ scandal

- ✓ February 24, 2012: FSA* imposed the business suspension and improvement order on AIJ Investment Advisors CO.,LTD.(AIJ)
- ✓ March 23: FSA imposed the discharge of registration and the business improvement order on AIJ.

Violation of Financial Instruments and Exchange Law

- 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, The Tokyo District Public Prosecutors Office prosecuted them. The court proceedings started on December 5.

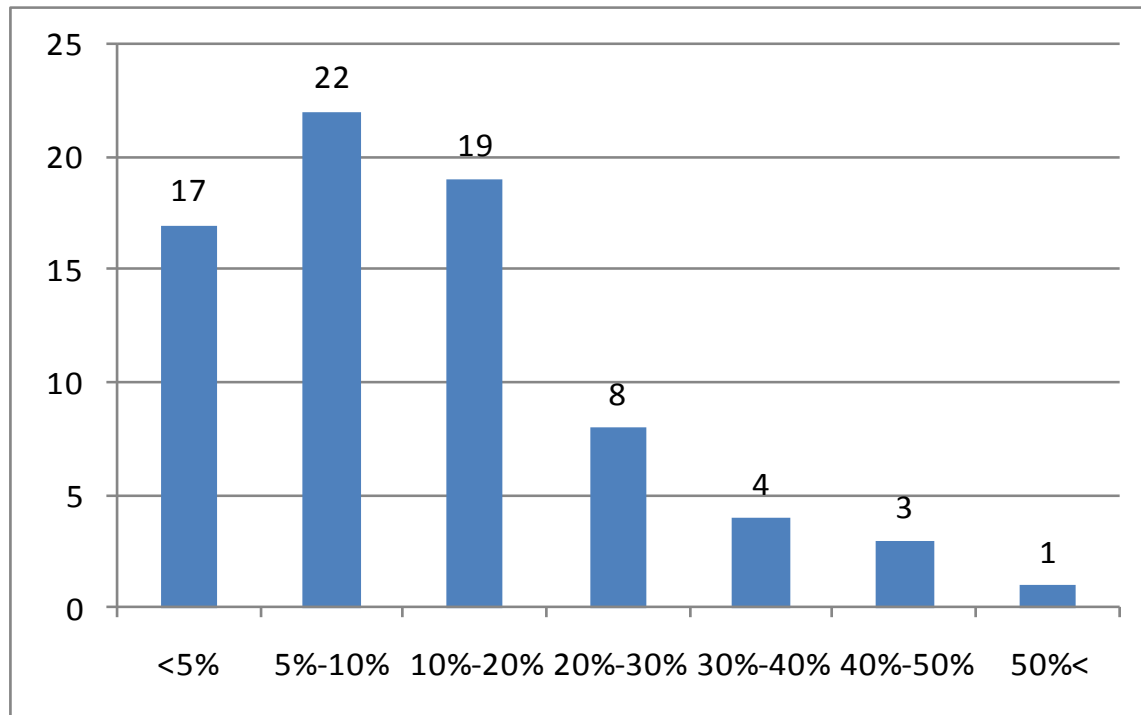
* Financial Services Agency

** Securities and Exchange Surveillance Commission

AIJ's major clients were pension funds

- ✓ 84 pension funds invested \186bil. (US\2.3bil.) to AIJ's investment funds
- ✓ 74 funds are Employees Pension Funds (EPFs), 10 funds are Defined Benefit Corporate Pensions (DBPs)
- ✓ 73 of the 74 EPFs are Multiemployer EPFs

Number of EPFs by ratio of AIJ's fund to their total assets



Raised Concerns

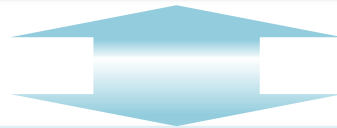
- ✓ Minimum Reserve of EPF is considered as a deposit for EPI, and it is incorporated in the fiscal outlook of EPI as an asset. If EPFs with assets less than Minimum Reserve were to exist, it might cause a loss for EPI in future.
- ✓ Prolonged economic slump and bad investment performances, together 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 created 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, 2013. 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.

Government's advisory committee

Pension Bureau of Ministry of Health, Labor and Welfare (MHLW) organized the advisory committee in April to consider the investment and financial issues of EPFs etc. The committee issued a report in July.

- ✓ Regarding EPF's future, the report pointed out that members' views were split.

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.



EPF scheme has played its important function in the diffusion of pension plans among SMEs. So the scheme should be maintained.

- ✓ On September 28, Ministry's working team, headed by Vice Minister, announced its policy to abolish the EPF scheme in the future. It also announced its plan to organize an "expert committee" in the Pension Council.

The “experts” committee and Reform Bill

MHLW organized the higher level committee called “experts” committee in November. The committee issued a report in February 2013.

Examining the substitution scheme in EPF

- Fine-tuning the definition of the Minimum Reserve
- Two step process to abolish the scheme;
 - ✓ encourage to terminate for EPFs with MR shortfalls, and to shift to other pension plans for EPFs without MR shortfalls in the first 5 years
 - ✓ enforce to shift to pension plans of other types or to terminate the plan in the next five years, and eliminate EPF system eventually

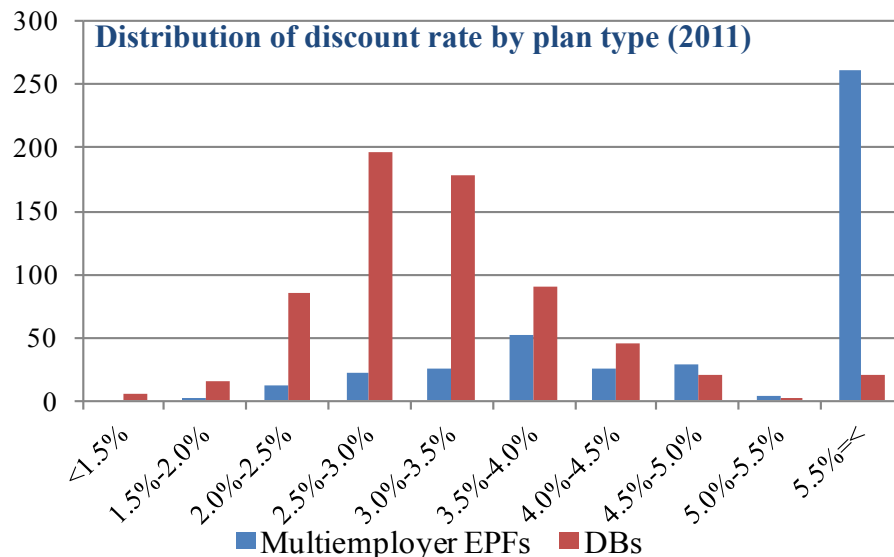
Following the general election in December, there was a political power shift from DPJ to LDP. LDP allowed the preservation of EPF and the government submitted the pension reform bill in April 2013.

- ✓ But the criteria in the bill to survive are very severe for EPFs, such as “EPF should have assets at least 150% of MR or 100% of the discontinuous base Actuarial Liability whichever lower”.

LDP made a compromise with opposition parties to amend the bill aiming at the elimination of EPF. And the amended bill passed the Lower House in May 23 and Upper House in June 19.

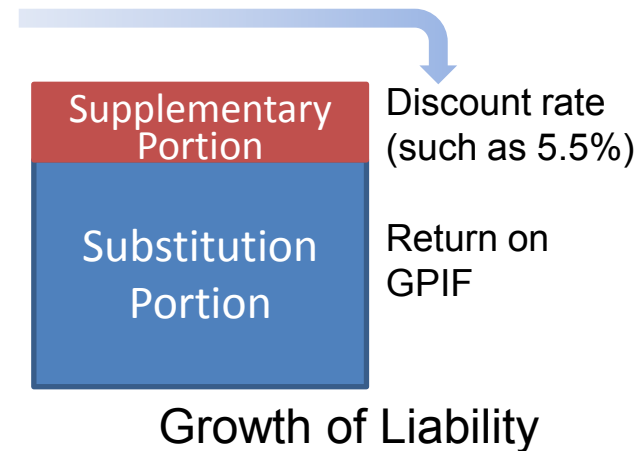
What caused the current challenges?

- ✓ Market conditions in 2000's: Many EPFs tried to recover the investment loss by the risky investment strategy rather than raising contributions.
- ✓ Low interest rates era: Many EPFs could not revise the discount rate for funding purposes.
- ✓ Lack of understanding of the financial neutralization in the substitution portion



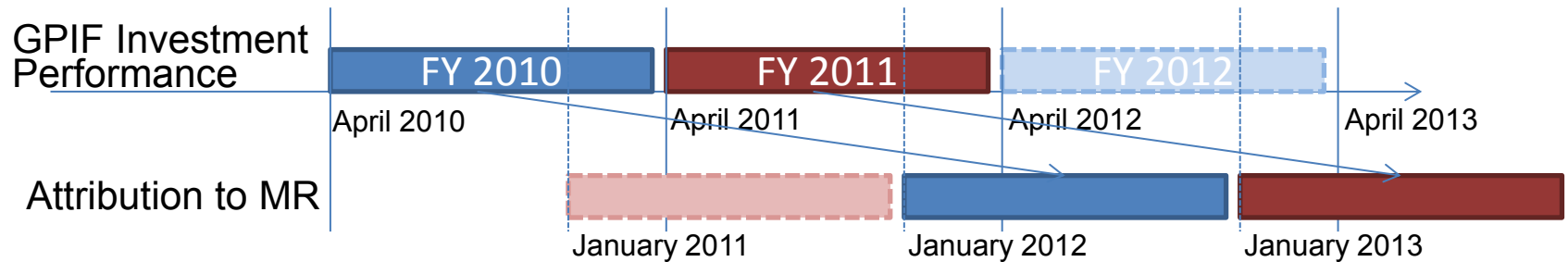
Source: Pension Fund Association

Discount Rate for Multiemployer EPFs is that for Supplementary portion

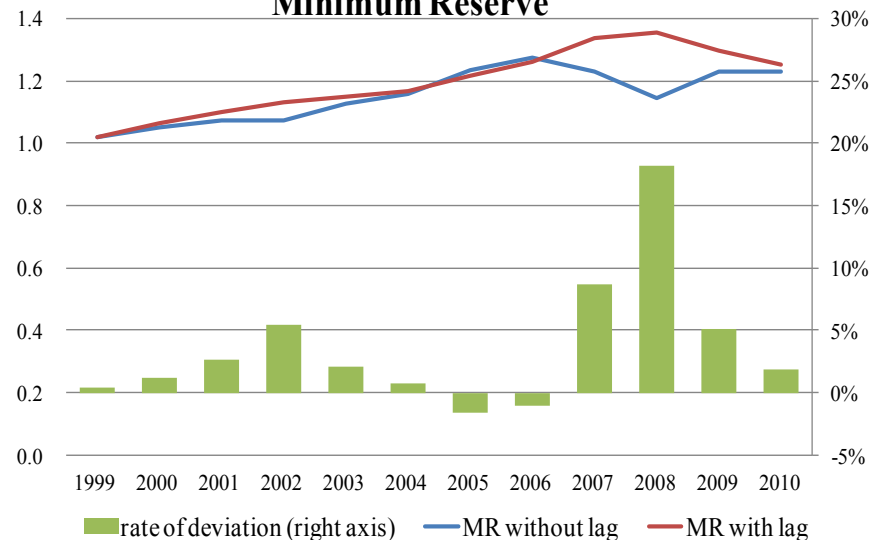


What caused the current challenges?

- ✓ Lack of well-considered guidelines: For example, 21 months lagged application of GPIF's performances to EPF's Minimum Reserve caused confusions in the plan management.



Effect of Lagged Interest rates applied to Minimum Reserve

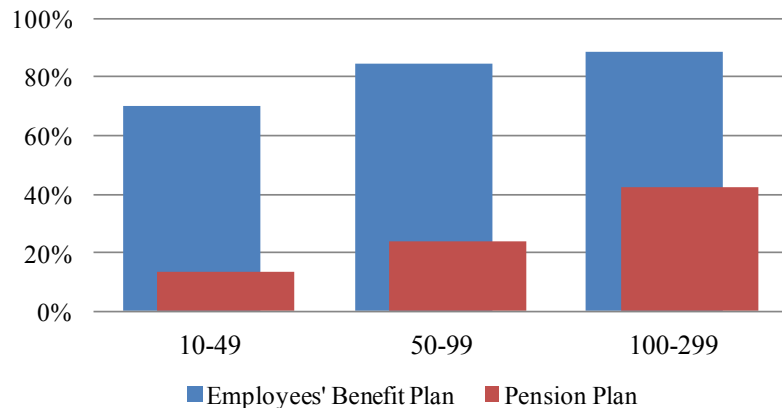


Source: Author's estimation

Potential effect of EPF elimination

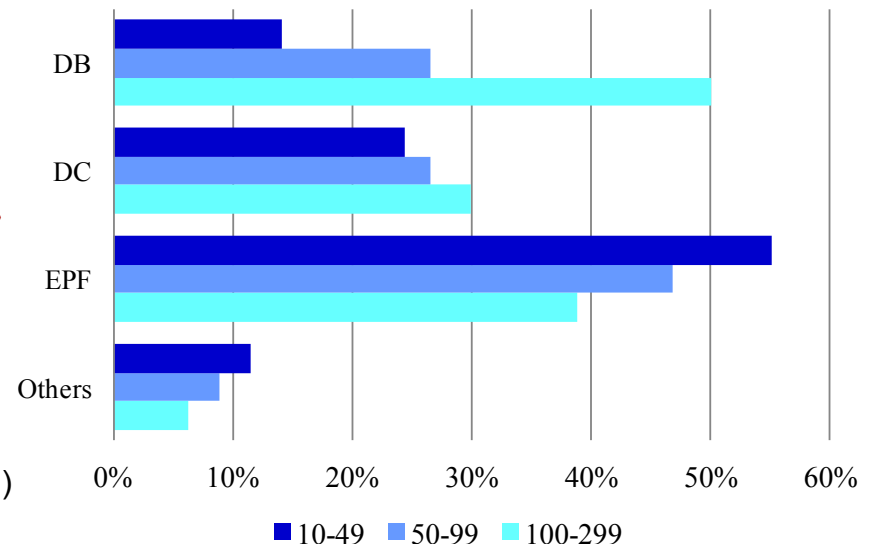
- ✓ Because most EPFs are Multiemployer Plans and their average number of employees per place of business is less than 40, the elimination of EPF might cause the issue of disparity in the pension coverage among company sizes.
- ✓ This issue might go beyond EPFs. It might be a concern for occupational pension systems as a whole.

Percentage of Employers with Plan by size



Source: Tokyo Metropolitan Government (2012)

Adopted Pension Plan type by size



Lessons from failures and measures for recovery

- ✓ God is in the details: Regulators should stipulate well-considered regulations.
- ✓ Understanding and communication of pension governance
- ✓ Occupational pension scheme for SMEs
- ✓ Advance consensus for the ex-post redistribution (or risk sharing) among related parties



The milk is about to spill out.
But we should minimize the spill amount beforehand.

Thank you for your attention!

Any comments will be greatly appreciated.