Protection of Participants and the Pension Benefit Guarantee Program of Japan

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Four Key Points for Protecting Rights of Private DB Plan Participants

1. **Fair and Extensive Entitlement to Pension**
   - Minimum standard on eligibility and vesting, plus universal mechanism of portability (cf. OECD Core Principle 5)
2. **Proper Advance Funding**
   - Funding Standard should not be excessive (cf. Core Principle 1).
3. **Efficient Investment Based on Risk Tolerance, Enforcement of Fiduciary Duties and Disclosure**
   - However, fiduciary duties are not powerful tools for protecting rights of participants (cf. Core Principle 4).
4. **Preservation of Participants' Rights in the Case of Benefit Modification and Plan Termination**
   - Benefit guarantee schemes exist in close collaboration with the above three measures (cf. Core Principle 3).

Countries with Statutory Benefit Guarantee Scheme

- United States of America (PBGC)
- Germany (PSVaG)
  - Note: Luxemburg is covered by the PSVaG
- United Kingdom (PPF)
- Sweden (FRG/PRI)
- Finland (Garantia)
- Swiss (Sicherheitsfonds BVG)
- Canada (Ontario State)

Seven Aspects on Benefit Guarantee Schemes

1. **Expected Role of Corporate Pension**
   - Weight within the overall old-age income security of the county
2. **Relation between Reserve Funds and Sponsor Companies**
   - Principle: External funding (Cf. Core Principle 2)
   - Paying consideration to the fund raising issue of sponsor companies
3. **Legal Treatment of the Obligation to Pay Vested Benefits to Participants after Plan Termination**
   - Prerequisite: Proper vesting rules that give participants legally unforfeitable rights to receive benefits
   - Vested rights of participants should continue as claims on sponsor companies after plan termination.

Seven Aspects on Benefit Guarantee Schemes (continued)

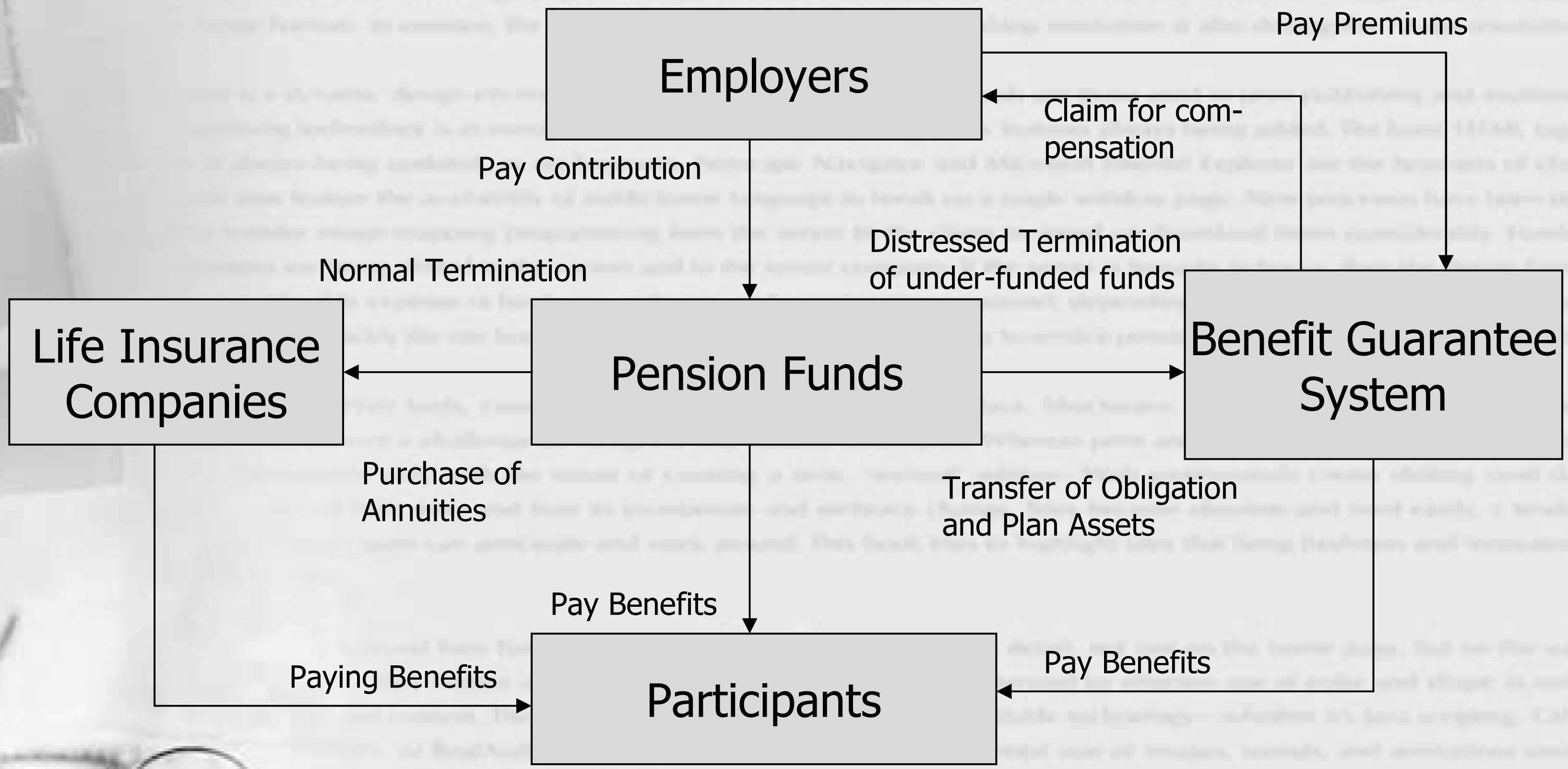
4. Priority Order of the Claims on Sponsor Companies in Comparison to Other Creditors

- Should be high as much as possible, next to collateralized claims and tax (cf. Core Principle 3, 3rd para.)

5. Transfer of the Claims on Sponsor Companies from Participants to the Benefit Guarantee Scheme

- Upon taking on the obligation of the terminated plan through subrogation
- Claims to <u>pension</u> on sponsor companies may be converted to claims to <u>lump sum</u> actuarially equivalent to the pension taken on by the Benefit Guarantee Scheme.

A Model of Benefit Guarantee System
-- Using the Mechanism of Subrogation and Acquisition of Claim for Compensation --



Seven Aspects on Benefit Guarantee Schemes (continued)

6. **Preservation of Participants' Claims to Annuities**
   - Not same as guaranteeing lump sum equal to the present value of vested pension benefits
   - Providing annuity option may be one of the raison d'ê·tre of corporate pension scheme, in the context of income security of the county.

7. **Prevention of "Moral Hazard" Activities**
   - Corporate pension is based on the principle of self-responsibility of sponsor companies.
   - Preventing employers from doing moral-hazardous activities is essential for materializing an impartial benefit guarantee scheme.

Rational Grounds for Benefit Guarantee Schemes

(1) Rigid funding rule requiring full funding at all times on discontinuance (annuity purchase) basis does not stand for sustainability of DB pension (cf. Core Principle 1, 1st para. & Core Principle 3, 1st para.)**.**

- DB plans invest assets with long-term perspective. Excessively conservative funding rule lessens investment return and makes DB plans costly and unattractive.
- Rigid funding rule may also distort market.
- Some people say that recent trends of accounting standard toward the "mark to market" principle will drive DB scheme away on the verge of extinction.

Rational Grounds for Benefit Guarantee Schemes (continued)

(2) Possibility of plan termination due to bankruptcy or similar financial difficulties of sponsor companies is very small.

- It seems economically inefficient to require all DB plans fully funded at all times on discontinuance basis, in preparation for such small possibility.
- Clarifying termination liability and creating some insurance mechanism will be probably more cost-effective.

(3) Participants' claim to annuity cannot be preserved by funding rule alone.

- Participants cannot hedge longevity risk individually.
- Some mechanism of annuitizing lump-sum distributed by the terminated plan at low cost is indispensable.

Rational Grounds for Benefit Guarantee Schemes (continued)

(4) We cannot completely prevent DB plans from terminating with shortage of assets <u>by manipulating funding rule</u>.

- Especially when sponsor companies go bankrupt or face financial difficulties

(5) Credit-worthiness of DB plans cannot far surpass that of sponsor companies in the long run.

- There is no one-to-one correspondence between individual claim rights and assets.
- Claim rights continuously accrue and vanish as time passing by.

Rational Grounds for Benefit Guarantee Schemes (continued)

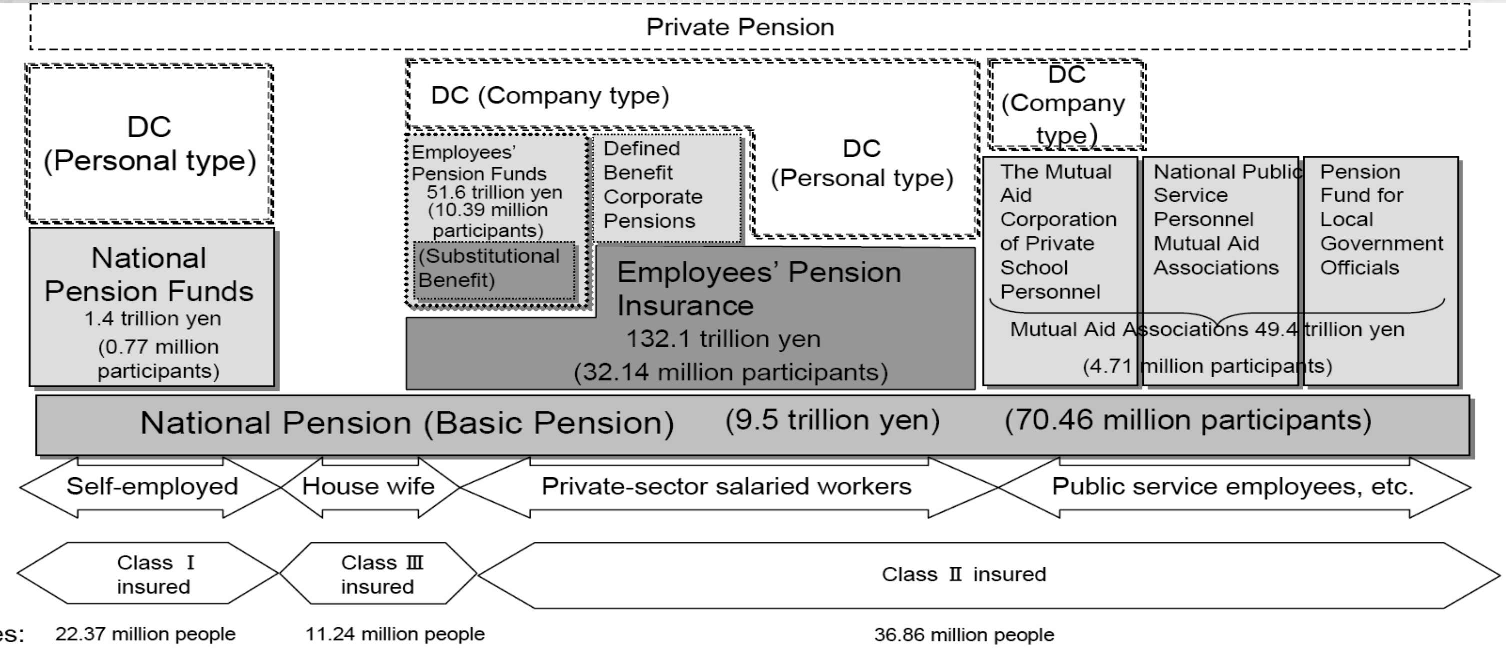
(6) Without some guarantee scheme, selecting annuity option is not always advisable.

- DB scheme should be trustworthy enough as a pillar of old-age income security (cf. Core Principle 3, 4th para.).
- We cannot forget the fact that DB plans are given social support through favorable tax treatments.

(7) In comparison to bank depositors, DB plan participants do not have freedom to choose a plan where their money shall be deposited.

- Therefore, some mechanism corresponding to the deposit insurance mechanism in banking industry is highly needed (assignment of obligation from participants, etc).
- Smooth re-organization of a bankrupt company requires a person acting in behalf of large number of participants, who are creditors of the company.

Positioning of Corporate Pension in Japan



Notes:

1. The number of participants and reserves are as of the end of March, 2003.
2. Public Pension Schemes in Japan are composed of two state pension schemes (National Pension and Employees' Pension Insurance) and three Mutual Aid Pension Plans.
3. DC; Defined Contribution. Defined-Benefit Corporate Pensions took effect on April 1, 2002.Tax-Qualifies Pension Plans (21.4 trillion yen, 8.59 million participants) will change over to other Company Pension Plans etc till March, 2012.
4. Mutual Aid Association of Agriculture, Forestry and Fishery Corporation Personnel combined with Employees' Pension Insurance on April 1, 2002.
5. Breakdown of Mutual Aid Associations (As of the end of March, 2003)
   National Public Service Personnel Mutual Aid Associations (8.7 trillion yen, 1.10 million participants)
   Pension Fund for Local Government Officials (37.5 trillion yen, 3.18 million participants)
   The Mutual Aid Corporation of Private School Personnel (3.2 trillion yen, 0.43 million participants)

Source: Ministry of Health, Labour and Welfare. Drawn by Institute of Pension Research, Nikko Financial Intelligence, Inc.

Source: Nikko Financial Intelligence

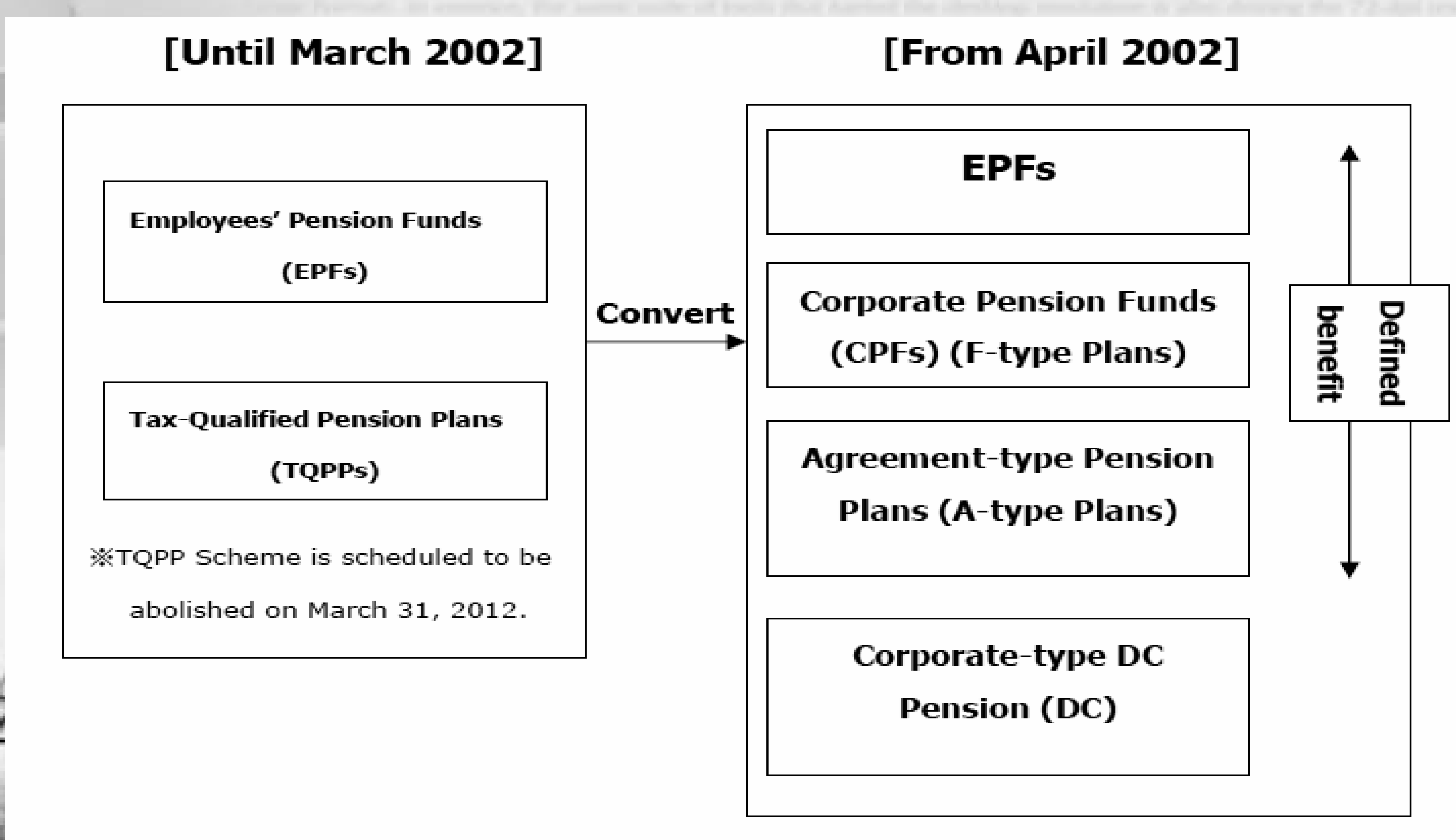
Spread of Retirement Benefit Scheme in Japan

(%)

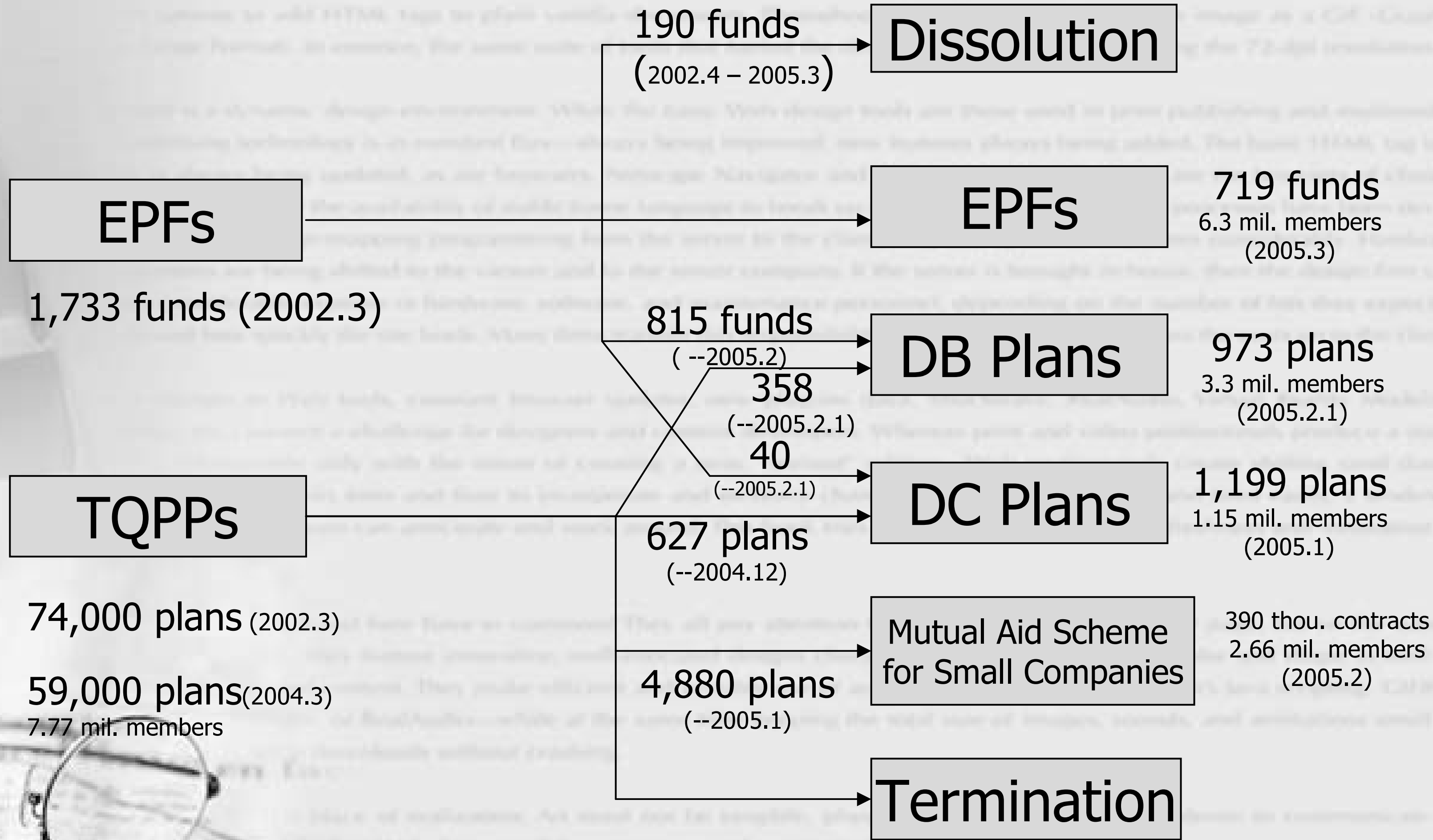
	Companies with retirement or separation benefit plans			Companies with any kind of retirement and/or separation allowance programs
	Lump-sum payment only	Annuity only	Lump-sum payment and annuity combined	
Overall (2003)	40.3	17.0	29.4	86.7
By number of employees				
30 –99 employees	45.8	15.5	23.5	84.7
100-299	31.1	19.3	39.1	89.5
300-999	21.7	25.3	48.7	95.7
1000 and over	10.7	18.5	67.9	97.1
Overall (1997)	42.2	18.0	28.6	88.9
Overall (1993)	43.2	17.1	31.7	92.0

Source: The Comprehensive Survey on Working Conditions (Ministry of Health, Labor and Welfare (MHLW))

Japanese Corporate Pension Entered New Era in 2002



Conversion from EPFs and TQPPs to EPFs, DB or DC Plans



Characteristics of EPFs (with Reference to Protection of Participants)

1. **Given a status of public legal entity**
   - Separate from sponsor companies
2. **Equipped with power of compulsorily collecting contribution**
   - Not limited to collecting contribution corresponding to social security premiums
   - Suitable arrangement for managing multi-employers plans
3. **Claims for contribution on sponsor companies are given a priority order of credit next to tax**
   - Higher than ordinal labor credits

Relation between Social Security Pension and the EPF Scheme

	Pension Benefits for Employees Not Covered by the EPFs		Pension Benefits for Employees Covered by the EPI
			Occupational benefits (The Supplemental Component)
EPI	The EPI old age pension (without cost of living adjustment and wage indexation)	➡	Benefits of the Substitution-portion (= the EPI old age pension without cost of living adjustment and wage indexation)
	The EPI old age pension (portion corresponding to cost of living adjustment and wage indexation	➡	The EPI old age pension (portion corresponding to cost of living adjustment and wage indexation
National Pension	Old age basic pension under the National (Basic) Pension		Old age basic pension under the National (Basic) Pension

☐ Paid by the Government

☐ Paid by the EPFs

Termination Liability of EPFs

1. **The new DB Corporate Pension Act (DBCPA) has introduced the legal concept of "Minimum Preserved Benefit (MPB)" for both EPFs and DBPs.**
   - Defined for each participant as his/her vested or regarded-to-be-vested benefit corresponding to his/her past service period and the benefit provision of the plan.
   - At present, neither of the schemes have any vesting rule for active participants.
   - Historically, employers are permitted reducing severance allowance (origin of corporate pension in Japan) for active employees under specific circumstances (the Supreme Court precedents).
   - At the time of creating the DBCPA, it was therefore difficult to introduce requirements of vesting legally unforfeitable claim rights to active participants.

Termination Liability of EPFs (continued)

2. **Sum total of the present value of MPBs minus the amount of plan assets is treated as uncollected contribution (i.e. liability) of sponsor companies when the plan terminates.**

- Sum total of the present value of MPBs is called as the "Minimum Funding Standard Amount (MFSA)".
- However, for the time being, each EPF is allowed to reduce the MFSA by itself, provided that the Reduced MFSA is not less than the "Minimum Technical Provision of the Substitution Portion (MTPSP)".
- The MTPSP is the liabilities of the "Substitution Portion (SP)" that the EPF Bears (see slide 16).
- The MTPSP is calculated in retrospective manner, using the actual rates of return achieved by the Social Security Fund (GPIF).

Dissolution (Termination) of EPFs

1. **Credits for uncollected contributions of EPFs are given a status of preferential claim rights on sponsor companies.**
   - Uncollected contribution includes the shortfall of assets (see slide 19) at the time of plan dissolution.
   - Priority order is next to national and local tax (see slide 16), in the procedure for reorganization, rehabilitation or liquidation of sponsor companies.

2. **Approval of the MHLW is required in order to dissolve an EPF based on the resolution made by the board of trustees.**
   - ◆ Amount of plan assets should be greater than the MTPSP.

Normal Procedure after Dissolution of EPFs

1. **The Pension Fund Association (PFA) collects amounts equal to the MTPSP.**
   - ◆ In exchange of collecting the amount equal to the MTPSP, the PFA provides annuity corresponding to the SP. In this way, the SP benefits are 100% guaranteed.

2. **Dissolved EPFs distribute residual assets to plan participants.**
   - Theoretically speaking, claim rights of dissolved EPFs for shortage of assets on sponsor companies should also be distributed to participants.
   - However, almost all EPFs have reduced the MFSA to the lowest level (equal to the MTPSP).
   - Dissolved EPFs are exempt from all obligation of paying out benefits afterward.

Normal Procedure after Dissolution of EPSs (continued)

3. **Every participant <u>can choose the manner of receiving his/her share of residual assets</u>.**
   - As a lump-sum
   - As an annuity

4. **In the latter case, his/her share is delivered directly to the PFA, as the capital of the annuity.**
   - The annuity that the PFA provides (PFA Annuity) is a defined-benefit life annuity with guaranteed period of payment.
   - The amount of PFA Annuity is based on the amount of delivered capital and the discount rate determined by the PFA.
   - Therefore, even if there were no shortage of assets at the time of dissolution, the benefit level of the PFA Annuity is not always same as those which the participants were promised previously.

Legal Basis of the Pension Benefit Guarantee Program for EPFs

1. **The Employees Pension Insurance Act (EPIA) states that the PFA is able to carry out the Pension Benefit Guarantee Program.**
   - With approval of the MHLW
   - The Program supplements the PFA Annuity to be paid to participants of dissolved EPFs by adding the Program Benefits as capital with certain limits, in order that their previously promised pension benefits are met as much as possible.
   - The Program is financed by the contribution paid by all member EPFs.

2. **The EPIA does not describe the Program in detail.**
   - This implies that the Program should be designed and operated appropriately based on the consensus of member EPFs.

Essential Characteristics of the Program

1. **A mutual aid system of EPFs**

2. **Aims at securing MPBs <u>within certain limits</u>,**
   - in the case of “inevitable” dissolution, due to bankruptcy or business deterioration of sponsor companies

3. **Based on the understanding that every EPF makes its best efforts to secure rights of its own plan participants**

Participation to the Program

1. **The PFA Article states that <u>all member EPFs</u> should participate in the Program.**
   - Generally speaking, insolvency insurance programs cannot be sustained without the basis of obligatory participation.
   - In 1989, the MHLW gave approval of implementing the Program on the condition that the PFA Article states obligatory participation.
   - In 2001, the PFA General Assembly unanimously adopted a resolution of reconfirming that relevant prescriptions of the PFA Article state the obligatory participation.

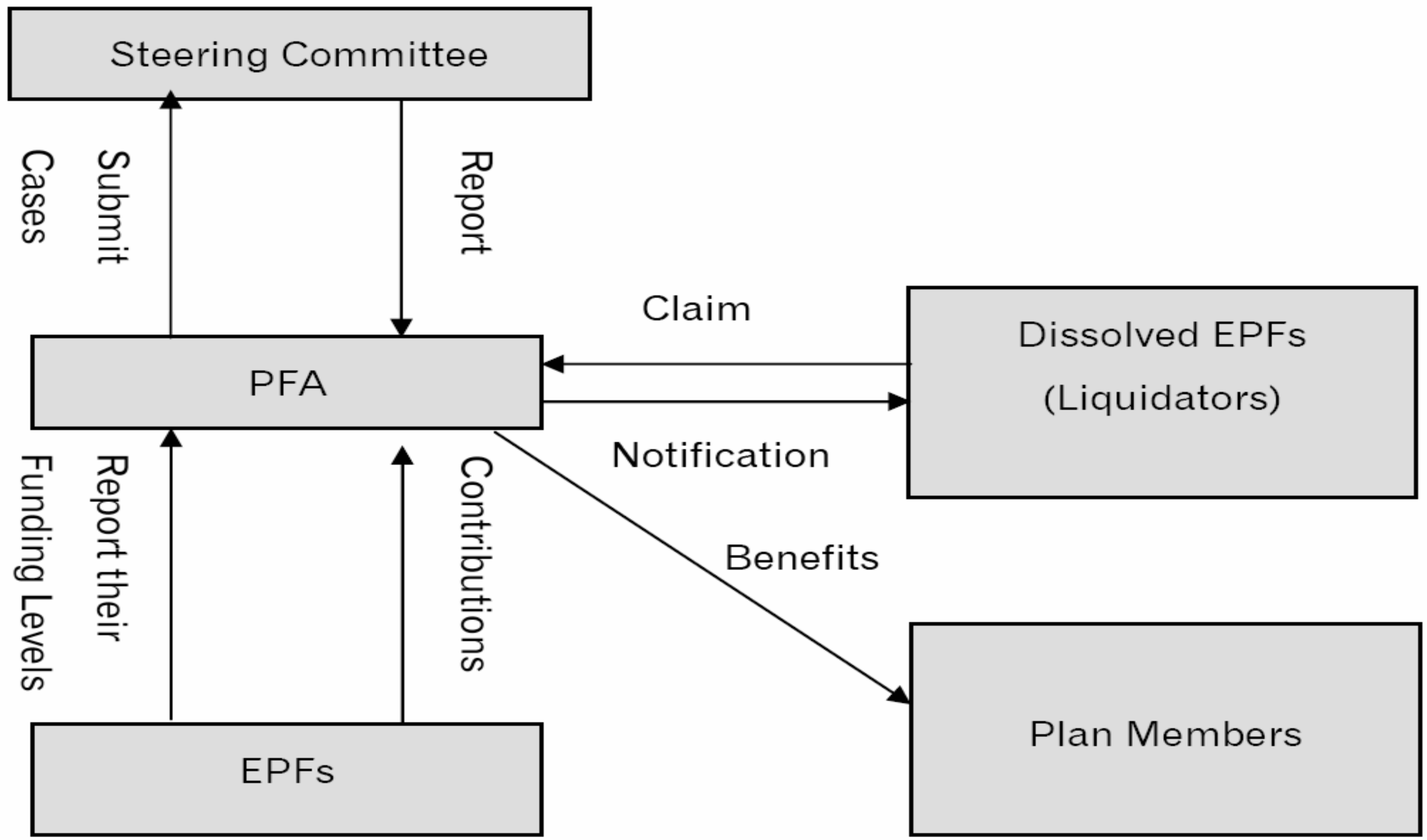
2. **The PFA is operating the Program under the endorsement and co-operation of all member EPFs.**

Governance of the Program

1. **The Program is operated under the control of the Steering Committee.**
   - The Committee is composed of representatives of member EPFs.
   - The PFA is operating the Program complying with the Committee recommendations.
     - Whether to apply the Program Benefits to individual cases
     - Whether to reduce the Program Benefits (and to what extent)
     - The Committee also investigates key issues such as benefit structure, ceiling on guarantee, contribution of member EPFs to the Program, etc.

2. **Thus, the Program is self-governed by EPFs, and <u>not</u> directed by the Government.**

Role of the Steering Committee



Suggestions Given by the PBGC (US) in 1988

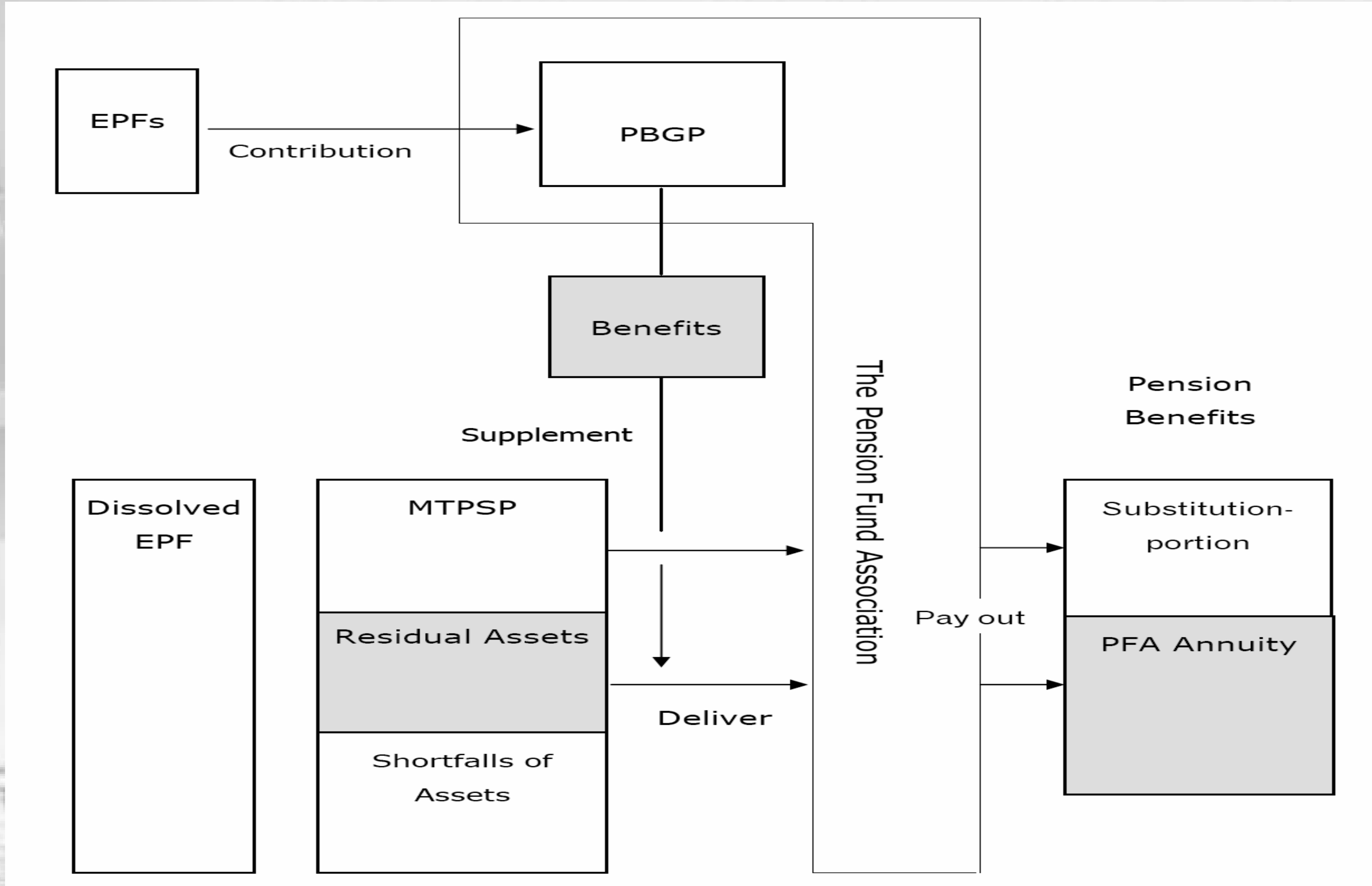
1. **To make the program simple as much as possible**

2. **Not to extend the guarantee range beyond your financial capability**

3. **To make efforts to prevent dissolution of under-funded plans**

- **These three suggestions determined the basic structure of the Program which started its operation in 1989.**

Flows of Contributions and Benefits



Cases to which the Program Benefits are Applicable

- **The Program Benefits are applicable to "inevitable" dissolutions due to**
  1. Bankruptcy of sponsor companies
  2. Business deterioration of sponsor companies or industries as a whole which sponsor companies are belonging to
  3. Or other circumstances under which the sponsor companies are considered to have been unable to sustain the EPF

- **Extending (i.e. easing) applicable cases is very difficult, because:**
  - The Program Benefits are "benefits" to the letter, and there is <u>no possibility of being paid back</u> by the sponsor companies afterward.

Criteria of Applying the Condition 2 & 3 (for Single-Employer EPFs)

1. The Sponsor Company:

a) The current balance had been in the red consecutively for the last several years before the dissolution, and

b) The balance sheet was in a situation that debts exceed assets or of cumulative deficits, excluding the retirement benefit provisions.

2. The EPF:

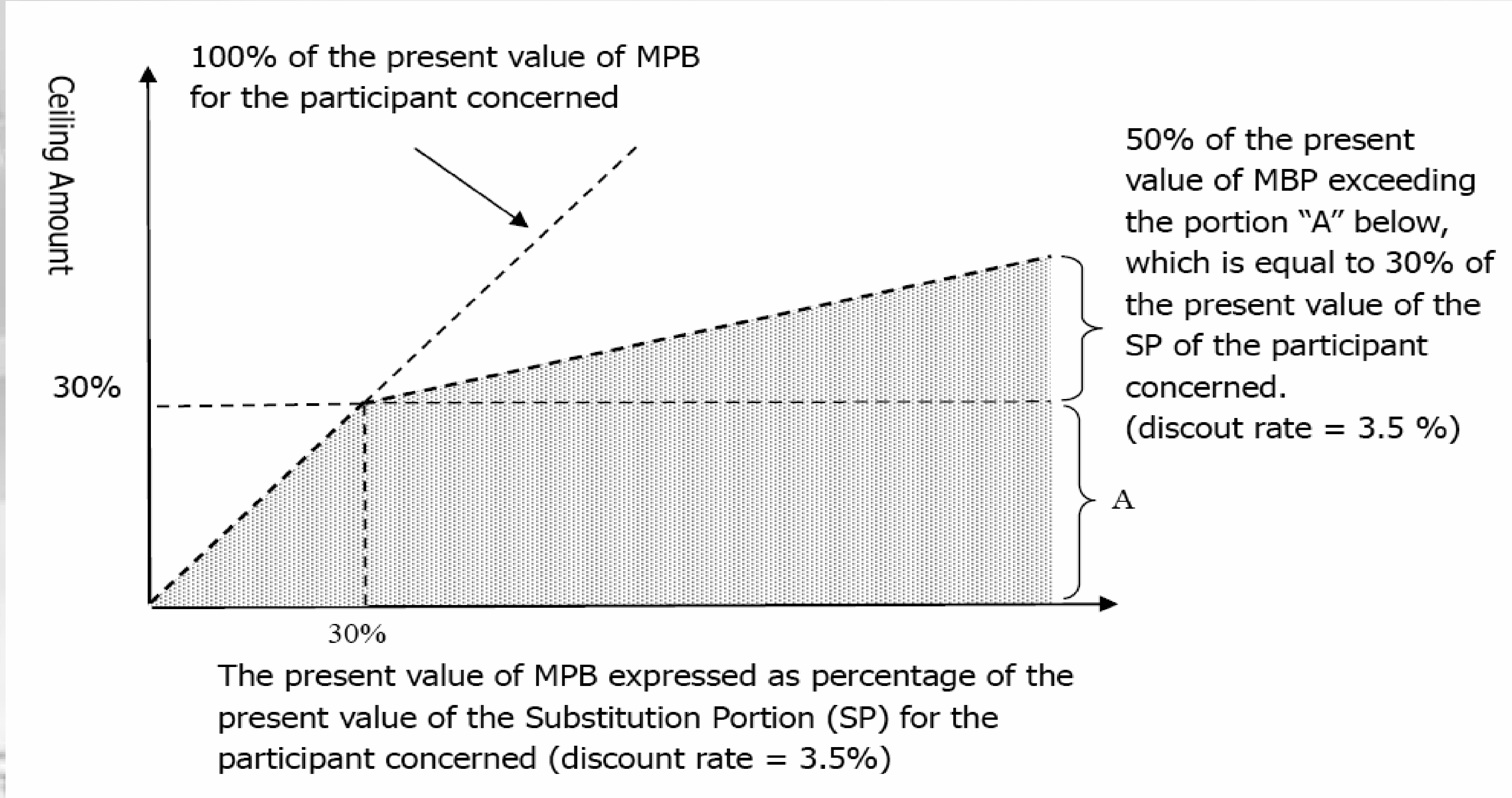
a) Number of the active participants had been decreasing substantially, and

b) Degree of plan maturity had been very high, and

c) Contribution rates had been considerably high in comparison with those of other EPFs with similar level of benefits, and further hikes of contribution were considered to be unavoidable

Ceiling on the Applicable Range of Guarantee for Individual Participants

(called as the Ceiling Amount)



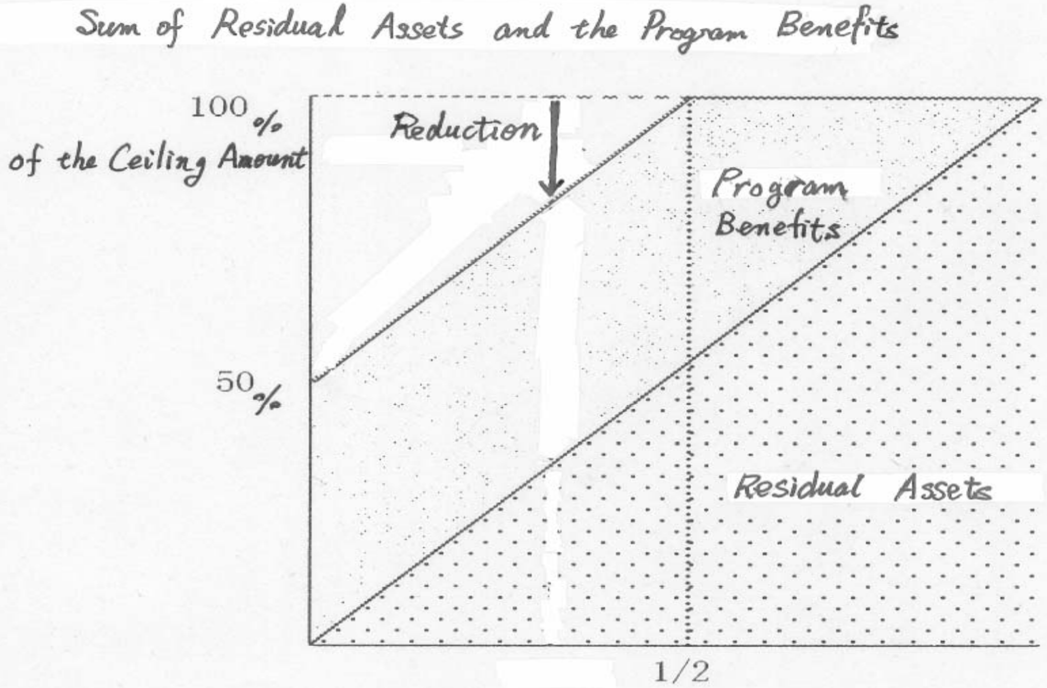
It should be noted that the discount rate for calculating present values of MPBs and the SPs is fixed at 3.5 % for the time being. Meanwhile, the discount rate for calculating the MFSA is 5-year average rate of return of 30-year JGBs.

Ceiling on Sum Total of the Ceiling Amounts

1. **In principle, the Program Benefits shall be equal to the Unfunded Liability.**
   - Unfunded Liability = Sum total of the Ceiling Amounts of all participants minus the amount of residual assets
   - <u>The Program Benefits are applicable only to participants who selected the annuity option (PFA Annuity).</u>
2. **However, ceiling of 7 billion yen is imposed on the amount of the Unfunded Liability.**
   - Corresponding to ceiling on the contribution to the Program (annually 65% of 9.681 million yen per fund (see slide 36))
   - This ceiling was introduced in 2000 to keep the Program solvent with affordable amounts of contribution.
   - Applying exceptionally large amount of the Program Benefits with no ceiling might collapse the Program and jeopardize impartial treatment of member EPFs.

Reduction of the Program Benefits Based on the Funded Status of the EPF

IF the amount of residual assets is less than half of the sum total of the Ceiling Amounts, the following reduction formula shall be imposed.



Note:

Ceiling Amount

$= \sum_i$ Ceiling Amount for each participant (i)

$$\text{Reduction Rate} = \left(1 - \frac{1}{2 \times (1 - \text{Residual Assets} / \text{Ceiling Amount})}\right) \times 100 \ (\%)$$

Reduction of the Program Benefits due to Inappropriate Management of the EPF

1. **When directors of the EPF are considered to have <u>neglected</u> their duties:**
   - The Program Benefits shall be reduced by up to 20% of the Unfunded Liability

2. **When administration or operation of the EPF are considered to have been <u>inappropriate</u>:**
   - The Program Benefits shall be reduced by up to 20% of the Unfunded Liability

3. **When appropriate measures has not been taken to secure assets after resolution to dissolve the EPF was adopted, and substantial amount of assets spilled out:**
   - The Program Benefits shall be reduced by up to 30% of the Unfunded Liability

Note: When the ceiling of 7 billion yen is imposed on the Unfunded Liability (see slide 33) , the Unfunded Liability" in the above statements shall be replaced by the Reduced Unfunded Liability after the ceiling was imposed on.

Contribution to the Program
(applied from 2005)

Contribution proportionate to number of participants		Contribution proportionate to sum total of the Ceiling Amount		Contribution proportionate to the amount of Unfunded Liability
45	:	45	:	10
114 yen per participant	+	0.083%	+	0.123%

<Upper Limit>
8.82 mil. yen per fund

<Upper Limit>
0.861 mil. yen per fund

Note: Furthermore, 35% reduction shall be applied to the amounts calculated by the above formula, by breaking into a part of reserves, spending 20 years.

Funding of the Program
(2004 Actuarial Valuation)

(in billon yen)

1.	Expected Annual Amount of the Program Benefits of the Next 5 Years:	1.22
2.	Contingency Reserve to Keep the Program Solvent for the Next 5 Years with 90% Probability:	10.85
3.	Expected Maximum Amount of the Program Benefits not yet Claimed by the EPFs Already Dissolved:	11.11
4.	Expected Operating Cost for the Next 5 Years:	0.50
5.	Amount of Reserves as of March 2005:	30.51
6.	Amount to Be Withdrawn {5 – (3+4+5)}:	8.05
7.	Annual Amount to Be Withdrawn Spending 20 Years:	0.45

Trends of Income and Outgo of the Program

(in million yen)

Fiscal Year	Contri-bution Income	Invest-ment Return	Special Revenue	Total Revenue ①	Paying out of Benefits	Invest-ment fee	Other Expenses	Total Expen-diture ②	Balance ①−②	Reserves
1990	651	58	—	709	0	4	—	4	704	1, 428
1991	706	77	—	783	0	6	—	6	777	2, 204
1992	771	113	—	884	0	8	—	8	876	3, 081
1993	825	393	—	1, 218	0	11	—	11	1, 206	4, 287
1994	848	196	—	1, 044	0	15	—	15	1, 029	5, 316
1995	859	276	—	1, 136	991	17	—	1, 008	127	5, 443
1996	865	244	—	1, 109	1, 094	17	—	1, 111	▲2	5, 442
1997	3, 804	186	64	4, 055	543	14	4	562	3, 493	8, 935
1998	3, 833	162	—	3, 995	185	20	26	231	3, 764	12, 699
1999	3, 843	126	—	3, 969	94	26	16	135	3, 833	16, 532
2000	3, 766	575	—	4, 342	119	29	5	153	4, 189	20, 721
2001	3, 851	136	—	3, 988	0	42	18	61	3, 927	24, 648
2002	3, 593	1, 075	—	4, 668	584	46	12	643	4, 026	28, 674
2003	2, 633	▲560	—	2, 073	985	34	41	1, 060	1, 013	29, 687

1) The amounts of reserves are book values until 1996.
2) The "special revenue" in 1997 is the appraisal profit due to change of the asset valuation method from book value to market value.
3) The "other expenses are amounts gone into other activities of the Program.

History of the Program Implementation

(From April 2002 to March 2005)

No.	Fund Name	Date of Dissolution	Claimed Amount (in mil. yen)	Applied Amount (in mil. yen)	Reduction Rate (%)
22	Fund V	Feb. 2001	955	346	63.7
23	Fund W	Apr. 2001	296	Not applicable	-
24	Fund X	Jan. 2002	73	21	70.7
25	Fund Y	Sep. 2001	247	158	36
26	Fund Z	Oct. 2001	65	58	10
27	Fund AA	Apr. 2002	1,049	608	42
28	Fund AB	May 2001	780	377	51.7
29	Fund AC	Jul. 2002	31	16	50
30	Fund AD	Jan. 2003	477	331	30.6
31	Fund AE	Mar. 2003	936	Not applicable	-
32	Fund AF	Jan. 2003	368	328	11
33	Fund AG	Dec. 2002	264	151	43
34	Fund AH	Sep. 2002	1,829	611	66.6
35	Fund AI	Feb. 2003	652	Not applicable	-
36	Fund AJ	Mar. 2002	254	229	10
		Grand Total from the beginning	17,463	6,260	

Future Challenges

- **Introduction of a Statutory Pension Benefit Guarantee Scheme which Covers all DB Plans**
  - The Welfare Committee of both Houses of the Diet adopted resolutions requiring that the Government should give further consideration to the issue of introducing a statutory scheme, at the occasion of passing the Defined Benefit Corporate Pension Bill in 2001.
  - However, there is a sort of allergy in Japan, especially among employers, to giving support to another companies for the sake of preserving severance allowance.
  - Meanwhile, it might become needed for Japan to further enhance the role of corporate pension, standing on the firm basis of social security.