

*Beware the Defined*

## MESSAGE TO JAPAN

BY LES LOHMANN

*The Japanese are among the best savers in the world.*

*Do they really need defined contribution retirement plans to encourage more savings?*

*And do they need to take on more investment risk in a profoundly troubled market?*

*Introducing defined contribution plans into the already troubled Japanese economy could be the financial equivalent of kudzu.*

**J**apan is hurriedly finalizing rules to permit defined contribution (DC) plans for Japanese employees. The fact that Japan has been influenced enormously by the United States may be inferred from noting that the Japanese are calling them 401(k) plans! The arrangements are expected to be permitted from April 1, 2001. But are they needed in Japan?

Japanese brokers seem to believe that the answer to Japan's economic malaise is defined contribution plans, and those who

tragedy and/or antiselection favoring the selection of the annuity.

Book reserve system plans are funded entirely on the employer's balance sheet, and employers recognize at least a portion of these promises as a priority if they become insolvent. These plans can provide only lump sums, but, like the lump sum delivered by the externally funded plan, the payment is tax-favored. Both funding vehicles are designed to deliver the right benefit at retirement.

The typical Japanese retirement plan is a true final-pay plan that has little impact on the average worker. But it can have an enormous impact on workers who experience higher than average increases in earnings over their last few working years. It has often been said that a retirement plan should provide a level of benefits that will permit a career employee to live in retirement at about the same standard of living enjoyed while working just prior to retirement. Final-average

plans are capable of achieving that goal for all career employees. Career-average plans reward employees who coast in their waning years and penalize the ones who finish strong.

There are two serious differences between defined benefit (DB) plans and DC plans that affect sponsor costs and participant benefits. First, people can tolerate less risk and have shorter investment horizons than the trusts DB plan sponsors establish. Second, no plan participant ever gets the exact amount anticipated from a DC plan.

It's axiomatic that higher risks lead to greater returns in an investment portfolio. Due to their longer investment horizons, DB plan trusts can withstand longer periods of poor performance and accept higher risks, yielding greater returns. Assuming that a DC plan is designed to produce results at retirement that are similar to the DB plan it's replacing, costs will be dramatically higher. Often, 200 basis points is used as an approximation of the difference that risk and horizon make. Given the historically low "safe" returns in Japan, the absolute difference is probably

# Contribution Plan

recommend, draft, and pass laws in Japan apparently agree. But after 10 years of providing retirement plan actuarial services in Japan, I'm still surprised that the Japanese don't recognize the superiority of the private retirement plan system they have.

### Strengths of the Japanese Private Retirement System

■ *Benefit Design and Cost.* When designing retirement plans, an actuarial consultant ensures that the plan provide the right benefits to the right people at the right time, and that the cost of those benefits should be appropriate.

Japan's basic private system automatically provides both. Plan design is typically quite simple: a lump sum paid at retirement based on final pay and service. Insured plans (both those provided by insurance companies and those provided by certain trust banks) also provide annuities, usually equivalent actuarially to the lump sum. But the Japanese tax system so favors lump-sum retirement benefits that retiring employees usually take the lump sum, even when there's a chance for arbitrary

greater and the impact magnified. Sponsors who convert from DB to DC will have to pay this difference, assuming that benefits at normal retirement are designed to be unchanged from current levels.

One might question the assertion that the price is right. Unlike the United States, where the regulatory burden is seen as a major reason for the high cost of DB plans and a significant factor in the growth of DC plans, it's the investment climate in Japan that's seen as the culprit. The climate has been so bad for the past several years that retirement plan costs have been escalating. But everyone in Japan is subject to the same economic environment. While much of the rest of Japan is over-regulated (hence the investment climate), Japanese private retirement plans have largely been left alone.

The high-profile Japanese retirement plans that have been failing are hybrid plans known as employee pension funds (EPFs). Regulatory authority has prevented appropriate actuarial methods and assumptions from being used for these plans, leading to the existing predicament.

The actuarial funding method used doesn't recognize EPFs as private plans, looking to funding for future new entrants to make up for shortfalls existing today. Actuaries, accountants, and the investing public generally agree that the key actuarial assumption for a pension plan is the discount rate. In an environment where returns have been negative for some time, the enforced discount rate used to determine employer contributions to EPFs remains 5.5 percent, an impossibly high rate in today's Japan, leading to even more inadequate contributions.

In a typical Japanese private retirement plan, the plan sponsor is paying only for the benefits promised plus a small incremental charge for administration (sometimes not even incremental with a book reserve plan) and another for asset taxes (not applicable at all to book reserve plans). Despite being known as tax-qualified pension plans (TQPPs), these plans pay taxes.

The available investment earnings serve to lower out-of-pocket expenses. While external retirement funds seldom attract the same rate of return as funds invested in the business, the additional cost represented by lost earnings or increased borrowing costs is considered appropriate for the additional perceived security of an external plan. Of course, the hidden investment rate of return for a book reserve plan is the company's return on investment (ROI).

These funding vehicles (insured and book reserve plans) combined with the typical design, keep investment transaction

## Common Characteristics of Defined Contribution (DC) Plans

- DC plans recharacterize current pay. They function as retirement plans only because employee participants are not permitted to use accumulated money until they quit.
- Amounts paid by the employer sponsor to a DC plan are tax-deductible. Employers typically get to deduct amounts paid regardless of whether the plan is qualified since the amounts paid are a deductible employment expense to the employer sponsor.
- Benefits are taxable upon receipt. Any amounts not vested revert to the employer, perhaps creating a taxable event for the employer.
- Benefits are portable. At severance, plan participants get the immediate value of the lump sum calculated without regard to the period before normal retirement. There is no reduction for early retirement.
- DC plans shift risk from the employer to the employee when compared with DB plans.
- Employer costs of DC plans are more certain than DB plans.
- DC plans are career-average plans. They can't provide benefits related to the employee's final standard of living.
- No plan participant ever gets the benefits designed or expected from a DC plan. The participant gets the market value of the investment account at retirement. If investments have done well, he will get more than planned; if the market is down, he will get less than planned.
- DC plans encourage saving over consumption, often with a tax subsidy.

costs relatively low, despite the still extraordinarily high trading fees charged by Japanese brokers. Companies, especially the insurers and trust banks, have kept two important principles in investing the funds in their care: Dollar cost averaging, as opposed to market-timing purchases; and buy and hold. Those who have been "buying Japan" for the past six years will find they have ultimately bought a bargain. Another investment principle comes to mind: "Buy low and sell high."

The usual payment of benefits as a lump sum also reduces administrative costs in Japan. The North American practice of keeping track of small amounts for former employees and paying annuities to many retirees leads to higher administrative costs in addition to the perceived regulatory burdens. Administrative costs for Japanese DB plans are nearly identical to those anticipated for DC plans, assuming that the cost of individual allocation and record keeping demanded of DC plans is roughly equal to the cost of valuation for a DB plan.

■ **Portability.** Part of the concept of the "right amount" includes a need for portability. But what is a portable benefit?

This pension actuary's definition of portability is that an employee should have a reasonable chance of replacing lost pro-

jected normal retirement benefits when retirement occurs midcareer, with the net lump sum paid at that time and then invested.

In a perfect world, employers would permit new employees to transfer all their previously accumulated retirement assets into the employer's pension system. At retirement, the employee would receive a benefit based upon total service from the first employer, with no diminution for having worked elsewhere. Social plans achieve this result to a degree by insulating benefits from the source of employment. But they often fail to provide an appropriate benefit since the retirement benefit is typically based on the employee's career earnings rather than his final earnings (a career-average plan).

Since many private plans are final-average plans, the new employer is going to experience additional costs representing the benefits earned for pre-employer service but not purchased by the transferred funds. Few employers would agree to such an approach since they don't feel obligated to pay benefits based on service with a prior employer.

Further, the prior employer shouldn't have to provide additional assets to a departing employee just because the new employer's plan is more generous or because the employee has managed to get a significant increase in earnings.

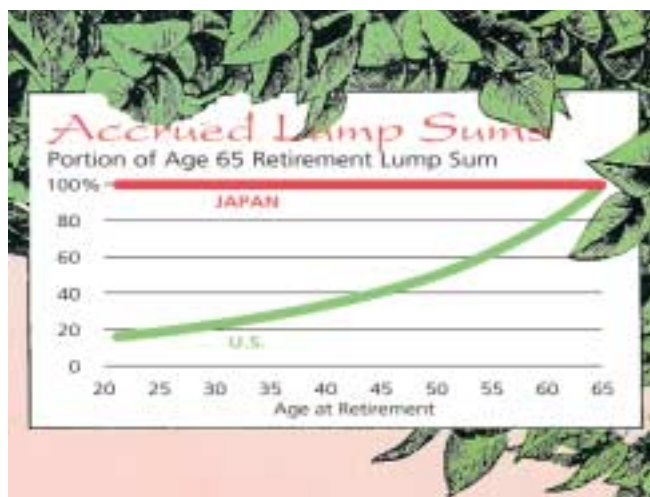
Realistic portability, therefore, is employees receiving a severance package that could buy the anticipated future benefit from the former employer when they retire at the normal retirement age of the new employer. Japan's current system as typically applied achieves this result—maybe better.

Typically, the Japanese employee's lump-sum benefit is calculated without regard to age at actual retirement. There are no early retirement penalties. The entire value is available to invest or, if there were a market in Japan, to buy an individual annuity to start immediately or at a later date. Japanese plans are mathematically front-loaded, based on how the deferred annuity is accrued over the employee's service lifetime.

Unlike Japan, North American DB plans have failed miserably at providing a reasonable degree of portability. The failure arises from two aspects of calculating the terminating employee's benefit: The amount is calculated as the present value of an annuity whose first payment is deferred, and the present value typically includes a discount for survivorship. These result in the increasing concave curve of termination values associated with North American plans, as shown by the lower line in figure 1.

Figure 1 illustrates the portion of the lump-sum value a retiring participant can get at each possible age of retirement, compared with 100 percent of the lump-sum value available at the retirement age limit with the same amount of service. The higher line shows the proportion a Japanese employee would get from a typical plan—always 100 percent. The lower one shows what an American employee might get. We have arbitrarily set both plans to a normal retirement age of 65 to ease the comparison, but it clearly doesn't make any difference to the Japanese employee since 100 percent is always available from the private DB plan.

Though Japanese plans weren't specifically designed to be portable, they are, due to benefit designs geared to the Japan-



ese practice of lifetime employment. Since few employees ever retired before the age limit, it was an unnecessary additional administrative burden to provide reduced benefits based on age at severance.

As shown, the Japanese employee gets a significant multiple of what his American counterpart does, magnified in the case of severance at a very early age. Taxes multiply the effect since, if Americans don't deposit their pittance into a qualified rollover instrument, they're generally taxed at their top marginal tax rate on the entire amount in the year of retirement. It's virtually impossible for American employees to successfully replace lost projected benefits with the amount they're provided at early re-

tirement. It's fairly simple for the Japanese employee.

Japanese plans further enhance the real intent of portability by distinguishing between voluntary and involuntary retirement. Employees who retire voluntarily have a chance to consider the benefits of their new opportunities. Involuntary retirees often don't. America treats all departing employees the same way, reducing benefits even when the company is responsible for the departure and the employee may be faced with a significant period of unemployment. These periods put projected retirement benefits at risk, since the former employee may need the money for current living costs.

■ **Investment risk.** Japanese employees can rely on getting the benefits they've been promised by their plan. They can plan and comfortably make retirement decisions, knowing that the amount they calculated will be available when they ask for it. Voluntary retirement is a big decision. Even Americans examine the pros and cons well in advance of making a decision to retire. A defined benefit assures the participant that the amount of money expected is the amount of money paid.

As with any other retirement plan delivering lump-sum benefits at severance, the participant assumes an investment risk after receiving the benefit. This characteristic holds for all plans. The lack of an individual annuity market in Japan tends to increase risks for Japanese retirees over their American counterparts, but this holds true for all disbursements.

■ **Discrimination in favor of the highly paid.** Both Japan and America embody the concept that socially favored (tax, security, etc.) retirement benefits should accrue equally to all employees. America has achieved this through a system of specific calculations that are expensive to calculate and administer and more difficult to understand.

Japan has achieved similar results by prohibiting employed members of the board of directors (officers) from having externally secured benefits and by requiring benefits to be the same for everyone. While there are weaknesses in the Japanese vehicle that have been exploited, one of the major reasons for em-

## Common Misconceptions of Defined Contribution (DC) Plans

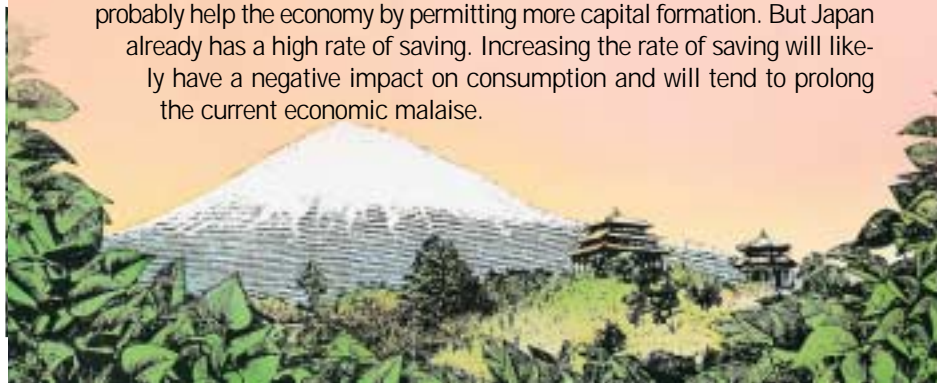
**INVESTMENT RETURNS FOR FUNDS IN DC PLANS ARE HIGHER.** Funds invested in DC portfolios have shorter horizons and generally lower risk. The long-term expected return of DC plan funds is significantly lower than the long-term expected return of DB plan portfolios. Illustrations of future results that use the same rate of return or a higher rate of return for DC plans versus DB plans are misleading and incorrect.

**DC PLANS COST LESS FOR EMPLOYERS.** Administratively, DC plans tend to have a larger number of smaller transactions than DB plans providing the same benefits, which can make them more expensive. The perception that they cost less is largely due to cost-shifting. In 401(k) plans, employer benefits depend on employee participation. Employees who refuse to participate are denied employer-provided benefits. Those employees who do participate are often expected to "buy" at least twice as much benefit as the employer matches. Funds are commingled, and employees fail to notice that employer-provided benefits are quite small!

**HIGHER BENEFIT SECURITY.** The individual account nature of DC plans gives a perception of benefit security. DC plan funds tend to be invested in lower risk vehicles than DB plans and thus the principal investment tends to be more secure over the short term, at a cost of reduced long-term investment return.

Because the current investment return problems in Japan are structural, DC plans will be subject to the same problems as DB plans currently are. Because most Japanese believe Japan is now in a period of recovery, investment gains will shift from the companies that have borne the risk for the past decade to the employees who did not.

**DC PLANS BENEFIT THE ECONOMY.** In the United States, where savings rates have been notoriously low and the expanding economy needs capital, DC plans probably help the economy by permitting more capital formation. But Japan already has a high rate of saving. Increasing the rate of saving will likely have a negative impact on consumption and will tend to prolong the current economic malaise.



ployers moving to DC plans in the United States is the perceived burden of the rules. Japan doesn't present such a burden.

Japan, along with most other countries, probably needs to fine-tune company insolvency laws. Remaining assets should be allocated first to accrued involuntary benefits promised by the retirement plan regardless of funding vehicle, then to unpaid salaries and allowances of rank-and-file employees. Officer-accrued retirement benefits should be the last item just before distribution of any remaining net worth to the owners.

### Weaknesses of the Japanese Private Retirement System

DC plans do not mitigate the following problems. Since they

typically try to look at total compensation rather than monthly base pay, DC plans actually increase discrimination in favor of the highly paid.

■ *Inadequate access to employer assets in insolvency.* As in America, the retirement benefits of regular employees are not protected in the event of sponsor insolvency. In private retirement plans, the difference between the total of involuntary benefits and the amount funded or recognized is not a legal liability of the employer.

In a TQPP, employees run a risk of not being paid their benefits before other creditors when their company fails. Though disclosure rules will at least inform investors and employees of the actuarial shortfall, these disclosure rules are based on an "ongoing entity" assumption. The shortfall between total involuntary benefits and the TQPP liquidation value (a number similar to market value) is not disclosed. More important, it's not a true liability of the company and doesn't have to be paid in an insolvency. In fact, it's not clear whether employees with externally funded plans even have standing as creditors in an insolvency.

Book reserve system plans present a similar problem. While the company must disclose the typically 100 percent of the voluntary termination amount as a liability, the difference between that amount and the involuntary amount isn't disclosed. (This percentage can be as low as 40 percent, but companies typically push it up to 100 percent fairly rapidly. There are rules to discourage reducing the percentage after it's been raised.) Employees do have some rights to remaining assets in an insolvency, but they're usually not sufficient to cover all amounts owed them under the retirement plan.

The FAS 87 concept of the accumulated benefit obligation (ABO) should be a minimum liability recognized on the balance sheet, with the total of involuntary benefits disclosed in a footnote. Solvency should be based on equity calculated after recognition of the minimum liability. Essentially, the ABO represents the ongoing present value of amounts currently owed employees based on their continued employment and the survival of the entity. It uses current service and current pay. This amount should be recognized regardless of the funding vehicle (insured or book reserve).

All benefits promised to rank-and-file employees should have a first right against remaining assets in a sponsor insolvency. The ABO would be replaced by the total of the involuntary benefits on the balance sheet as a minimum liability. These amounts would be paid before any other creditors were apportioned assets.

■ *Abuse of the definition of base pay in order to enhance benefits for the highly paid.* Retirement benefits should be based on the same base pay on which unemployment, health, and other social taxes are based. Bonuses and other allowances should not be included in any definition of base pay.

■ *Reliance on a "product" approach to external funding (insured plans).* Insured or TQPP plans should be established more on a trustee basis than the current "product" basis. The current basis severely distorts cash flows and reported income between generations of employees and owners.

Finally, there's another question that needs to be answered:

Who deserves the coming investment gains in Japan as Japan recovers? Should it be the owners of entities that have borne the pain of investment losses over the past few years, or the current employees who were protected during the entire time by DB plans? Would the alternative of making market adjustments be acceptable to employees or their government? Probably not.

DC plans can certainly make an important contribution to saving for retirement, but they are inappropriate as the basic retirement plan for rank-and-file employees. In a perfect world, private, tax-deferred investments would be a perfectly acceptable retirement funding choice, but DC plans should be used to create an extra layer of benefits on top of an adequate DB plan.

Japan has a working private retirement system with some weaknesses. Will these weaknesses be addressed by the introduction of DC plans similar to 401(k) plans found in the United States? Will Japan's economy be improved by the introduction of these new retirement vehicles? The Japanese investment broker community will benefit enormously by the increase in transaction fees, but we're unlikely to see any tangible increase in the output of goods and services from this change. In fact, the reduction in consumption related to the increase in saving would be a direct hit against the economy. ●

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