Japanese Pension System and Its Outlook
Executive Summary

The Japanese public pension scheme covers all people but so far a household of a retired individual seems to have received enough, but still the replacement ratio is one of the lowest among developed countries.

As claimed by the government that the pension is sustainable for the next 100 years and also forecasted the notion that the reserve will increase. However, the forecast rests upon extremely optimistic assumptions.

Pension reforms so far has worked on: (i) simplifying and integrating schemes; (ii) providing protection to the weak (people earning low wages, irregular workers etc.); and (iii) implementing mechanisms to ensure the sustainability.

Nevertheless, still there is a doubt of sustainability in the pension plans. The factors including: mechanisms used for sustainability such as benefit deflator, and the starting age of an individual must still be improved. Another large arena of discussion is about securing a public fund source. Pension reforms must be considered in conjunction with other economic policies, such as tax and medical/welfare reforms.
Overview of the Japanese Pension System

In a nutshell, there are three pension schemes, two among them are public pension schemes and the other is a private one and this cover three layers.

Layer 1
Basic Pension – Nation pays half of the premium

Layer 2
as much as you earn

Layer 3
voluntarily savings

1. National Pension

Group I.
Self-employed
(19.0 mn persons)

2. Employee Pension Insurance

Group II.
Employees
(38.9 mn persons)

3. Corporate and Private Pensions

Group III.
Housewives
(9.8 mn persons)

Source: Ministry of Health, Labor and Welfare website. Number of participants are as of March 2012
Overview of the Japanese Pension System

All Japanese people are covered by one of the two public pension schemes, the National Pension or the Employee Pension Insurance.

Group I.
Self-employed or small business owners participate in the National Pension (“NP” or “kokumin nennkin”), while they have opportunities to save more voluntarily. Non-workers also have to participate in it and pay the premium.

Group II.
Company employees participate in the Employee Pension Insurance (“EPI”, or “kousei nennkin”). Premium will be deducted from their salaries automatically, and employers’ contribute to match it. Most employers offer/introduce opportunities to accumulate more under various schemes, including defined benefit and defined contribution.

* Precisely speaking, public officials and teachers have separate mutual funds, but the recent reform has set these mutual funds to be merged into the EPI.
* The corporate sponsored private scheme is to be terminated as part of the recent reform, which aimed at integrating the public pension scheme into one single entity.

Group III.
Housewives are automatically considered part of the National Pension scheme, although they do not pay premium by themselves.
Overview of the Japanese Pension System

Three basic principles of the Japanese pension system are:

1. All participants must pay premium by law. They will be covered and evaluated by the pension scheme on a condition that they meet certain eligibility criteria.

2. The benefit will be paid life-long and also be adjusted. In short, you will receive in accordance to what you paid, but the benefit amount will be adjusted to macro-economic changes such as CPIs and wages.

3. In addition to the large reserve, it also includes features as an inter-generation support system. Premium paid by working age population is used to pay for the retired.
Overview of the Japanese Pension System

An average household above Age group of 65 seems to be receiving just as much as they spend on goods and services.

An average household above Age of 65 includes a husband and a wife. If the husband is under the Employee Pension Insurance and the wife is under the National Pension, the combined household income seems to be just equivalent to the average household consumption.

<table>
<thead>
<tr>
<th>Monthly Benefit Received by Actual Recipient (JPY) and Average Household Monthly Consumption Expenditure (JPY)</th>
<th>FY 2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Benefits Received</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>National Pension</td>
<td>56,787</td>
<td>56,873</td>
<td>56,954</td>
<td>57,017</td>
<td>56,893</td>
<td></td>
</tr>
<tr>
<td>Employee Pension Insurance</td>
<td>157,657</td>
<td>155,345</td>
<td>153,414</td>
<td>150,034</td>
<td>149,334</td>
<td></td>
</tr>
<tr>
<td><strong>Consumption Expenditure</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>218,781</td>
<td>216,897</td>
<td>212,847</td>
<td>213,217</td>
<td>211,336</td>
<td>214,266</td>
</tr>
<tr>
<td>Excluding housing and car</td>
<td>178,203</td>
<td>176,961</td>
<td>179,209</td>
<td></td>
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<td></td>
</tr>
<tr>
<td><strong>Average # persons per household</strong></td>
<td>1.99</td>
<td>1.95</td>
<td>1.95</td>
<td>1.94</td>
<td>1.96</td>
<td>1.97</td>
</tr>
<tr>
<td><strong>% owns houses</strong></td>
<td>85.7%</td>
<td>86.7%</td>
<td>86.7%</td>
<td>86.1%</td>
<td>85.7%</td>
<td>88.5%</td>
</tr>
</tbody>
</table>

International Comparison

The Japanese social security expenditure is about 10% of GDP, and is the 8th highest among OECD countries.

International Comparison

However, the replacement ratio is less than the OECD average. The Japanese pension system pays benefit worth c. 36% based on the last income earned by the retired.

The lower replacement ratio indicates that the Japanese retiree may not receive the same amount as he was receiving before retirement to sustain the same standard.

<table>
<thead>
<tr>
<th>Country</th>
<th>Replacement Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>32.6%</td>
</tr>
<tr>
<td>Japan</td>
<td>35.6%</td>
</tr>
<tr>
<td>US</td>
<td>38.3%</td>
</tr>
<tr>
<td>Canada</td>
<td>39.2%</td>
</tr>
<tr>
<td>Germany</td>
<td>42.0%</td>
</tr>
<tr>
<td>OECD Avg.</td>
<td>54.0%</td>
</tr>
<tr>
<td>Sweden</td>
<td>55.6%</td>
</tr>
<tr>
<td>France</td>
<td>58.8%</td>
</tr>
<tr>
<td>Italy</td>
<td>71.2%</td>
</tr>
</tbody>
</table>

Source: OECD, “Pensions At A Glance 2013”
Examining Sustainability

The government claims the system is sustainable for the next 100 years.

By law, the government conducts the Financial Verification of the public pension system to determine the soundness of the pension system once in every five years.

If the pension system can sustain a sufficient reserve to pay for the retired for next 100 years, it is viewed as “financially sound.” If not, then the government has power to implement a means to improve the system, for example, by cutting down the pension benefit.

The last Financial Verification in 2009 assured the system’s sustainability and the government claims the same.

Source: Ministry of Health, Labor and Welfare, “The 2009 Financial Verification” of the Public Pension Scheme. The National Pension and the Employee Pension Insurance Combined (ex. The basic pension)
Examining Sustainability

The Reserve has been continuously declining. The actual reserve amount is lower than the projection in the 2009 Financial Verification under the base case scenario.

Examining Sustainability

The assumptions used in the 2009 Financial Verification seem to be very optimistic.

The base scenario of the forecast assumed modest GDP growth, slight inflation, good wage growth and 4% of investment yield. The reality has been a sluggish economy with deflation in prices and wages.

<table>
<thead>
<tr>
<th>Government Assumptions</th>
<th>Historical Performance</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Optimistic</td>
</tr>
<tr>
<td>GDP Growth 2015-2039</td>
<td>0.8%</td>
</tr>
<tr>
<td>CPI growth</td>
<td>1.0%</td>
</tr>
<tr>
<td>Wage growth (nominal)</td>
<td>2.9%</td>
</tr>
<tr>
<td>Investment yield (nominal)</td>
<td>4.2%</td>
</tr>
</tbody>
</table>

Source: Ministry of Health, Labor and Welfare, “The 2009 Financial Verification” of the Public Pension Scheme
Examining Sustainability

GPIF’s yield has been, on average, 2.02% since FY2001. In most of the years, the pension fund’s investment yield is below the government assumption of 4.1% in the 2009 Financial Verification.

Government Pension Investment Fund (GPIF) is an independent agency which manages the reserve of the Employee Pension Insurance and the National Pension.

Examining Sustainability

GPIF is a medium for improvements, as in, by taking more risks in its investment approach with a larger group of investment professionals.

GPIF takes very conservative investment approach with about 61% of its assets in domestic equity. It also employs lesser investment professionals than the way it is executed in the other countries.

Solely, Improving investment yield is not enough to assure the sustainability of the pension system.

Breakdown of Assets Under Management

The System Reform and Prospective

In 2011, the Ministry of Health, Labor and Welfare identified five areas of issues.

1. The increased number of irregular workers.
   1. They are not to be covered under the pension scheme, or else they will receive only a little amount of benefit.

2. Impact on people’s choices.
   1. The difference in pension plans affect both employees’ and employers’ choice.
   2. Some potential labor may be discouraged by the existence of Group 3.

   Some receive only a little amount of pension or no pension at all

4. Anxiety over the system.
   1. High delinquency and distrust among the working age population

5. Anxiety over the sustainability.
   1. Public fund source has not been secured
   2. Need to increase the starting age
   3. The Macro-economic slide mechanism is not effectively balancing both income and expenditure.

The 2012 pension reform decided to one day establish a new and integrated pension scheme. Meanwhile, it aims at improving the current system in its simplicity, stability, and safety. However, discussions on fundamental solutions were postponed till the future.

**Adopted Measures**
- **Group 2 Integration**: Private and public employees to share the same EPI
- **National Contribution up to 1/2**: The nation to pay half of the basic pension benefits (1st layer)
- **Securing Public Fund**: Tax increases intended to secure a stable fund for pension benefit
- **Shorter Period to Pay Premium**: Must pay premium at minimum 10 years to receive benefits: down from 25
- **Extended Coverage**: To include part-time workers and other workers of irregular forms
- **Extended Exception**: Maternity leave added to the exemption to premium payment
- **Later Start**: Benefit to be paid at later age; gradually increased to 68
- **Improve Macroeconomic Slider**: To improve the effectiveness of this mechanism to balance the premium paid and the benefits paid
- **Restriction on Wealthy Elderly**: To limit their pension benefit

**Identified Issues**
- **Group 3 Termination**: Housewives also must pay premium

**(Unmentioned Issues)**
- Integrating of Group 1 and 2

**GOAL**
- **Single New System for Everyone**
  - (1) Benefit as much as you pay
  - (2) Guaranteed minimum standard
  - (3) Trusted as safe and sound

Source: Various materials from The Ministry of Health, Labor and Welfare and The Cabinet Office
The System Reform and Prospective

The 2012 reform addressed potentially inadequate pension in relation to the low income people in various forms. However, it was postponed to re-examine the benefits paid to a wealthy elder.

The coverage of the Employment Pension Insurance will be expanded to the short-time workers from the start of 2016. While people in maternity leave will be exempted from premium payment, and single-parent families can receive the bereaved insurance benefit starting from 2014.

Ideally, stronger support to the weak should come along with a review of benefits from the rich beneficiaries. Although a discussion took place related to it, and the 2012 reform excluded this issue from the concrete legal amendment items. The 2013 report by the Council for Intensive Discussion on Social Security Reform points out this to be a future issue and has to be reviewed.
The System Reform and Prospective

The government recognizes an issue with the current benefit deflator, or the so-called “Macroeconomic Slider” mechanism, which was introduced in the 2004 pension reform.

This mechanism aims at adjust benefits in line with changes in demographic and economic indicators so that the system will remain financially sustainable.

However, since it cannot be used in deflation, it has not been used and hence has not adjusted the pension scheme.

The 2012 reform identifies this issue but without mentioning concrete countermeasures.
The System Reform and Prospective

The government continues to examine possibilities of increasing the pension starting age.

It alone will not fundamentally solve the financial difficulties of the system. Based on the principle, you will receive as much as you pay. Additionally, due to the longer life expectancy, total benefits to be received by an individual is unlikely to decrease significantly despite the later start.

<table>
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<tr>
<th>Life Expectancy at Age 65 - Actual and Estimate</th>
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<tr>
<td></td>
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<tr>
<td>Male</td>
</tr>
<tr>
<td>Femal</td>
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</tbody>
</table>

The main impact it will have on the pension system is to alleviate the negative impact of the benefit cut on the pension beneficiaries. The cut may be smaller than it would be in a case where people start receiving benefits earlier.

The 2013 report by the Council for Intensive Discussion on Social Security Reform suggests that policies must come in package with a support measures for the old to work upon and the other to promote private savings/pension plans.

Source: The 2013 report by the Council for Intensive Discussion on Social Security Reform
The System Reform and Prospective

The discussion on the pension system will continue along with another on tax reforms. To secure the public fund for the basic pension portion is essential for gaining trust from the public.

Other than the benefit deflator mechanism and the higher starting age, safety for the lower income people and review of benefit to the rich will continue to be discussed.

In 2014, the Financial Verification will be conducted again. Its result will have impacts on the pension reform discussion.
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