

## Key theme

Corporate (private) post employment benefits

## Title

Consideration of Converting to Company-Group DB Pension Plans

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## Abstract<sup>2</sup>

In Japan, Tax-Qualified Pension Plans (TQPPs), which have been adopted mainly by medium-sized and small companies, are scheduled to be abolished at the end of March 2012. It is because TQPPs do not have enough protection of employee's benefit rights. However, if a small company converts the TQPP to another defined benefit (DB) pension plan, such as Defined Benefit Corporate Pension Plan (DBCPP) or Employees Pension Fund (EPF), is it easy for the employer to observe their strict regulations and continue its DB type pension plan?

One effective way is that the small company converts the TQPP to a Company-Group DB Pension Plan. When a lot of small weak DB pension plans gather, a large strong DB pension plan can be formed. Typical cases are as follows: (1) a small company unifies the TQPP with the allied-companies DBCPP adopted by its parent company, and (2) a small company incorporates the TQPP into a multi-companies DBCPP.

I have viewed some examples of Company-Group DB Pension Plan in Japan, with the result that I have found three main advantages, (1) Scale merit stabilizing finance, (2) System unification making simplicity, and (3) Portability of benefit rights.

Finally, I hope the scheme of Company-Group DB Pension Plan will contribute to survival of DB type pension plans in the future, not only in Japan but also in other countries.

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<sup>1</sup> Include affiliation(s) and contact details for corresponding author

<sup>2</sup> Maximum 300 words

Submit in English

Do not include graphics or diagrams

Define unfamiliar abbreviations and acronyms in full with first use



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## 1. Introduction

In Japan, one of the recent serious problems about corporate pensions is how the employers can manage their DB pension plan after TQPPs are discontinued. Japanese government established TQPP system in 1962 by giving favorable tax treatment. Ever since, many companies, especially medium-sized and small companies, have adopted TQPP as a main Japanese DB type corporate pension plan. But the Defined Benefit Corporation Pension Act (DBPA) was enacted in June 2001 with the purpose of strengthen protection of employee's benefit rights. Consequently, TQPPs are scheduled to be abolished at the end of March 2012. It is because that it does not have adequate funding requirement therefore it is considered unsuitable pension plan for protection of employee's benefit rights.

If employers adopting TQPP want to continue their DB type pension plan with favorable tax treatment, they must convert the TQPP to another DB pension plan, such as DBCPP or EPF \*. However, both DBCPP and EPF have strict regulations about funding requirement, fiduciary responsibility, and reporting and disclosure.

Can a small company easily observe such strict regulations in the recent economic recession? If not, how can it continue their DB type pension plan?

One effective solution is that the small company converts the TQPP to a Company-Group DB Pension Plan. Company-Group DB Pension Plan means a DB type corporate pension plan which consists of many companies. It is difficult for one small weak company to manage its DB pension plan by itself. But when a lot of small ones gather, they can manage a large strong DB pension plan.

Typical cases of Company-Group DB Pension Plan in Japan are as follows:

- (1) a small company unifies the TQPP with the allied-companies DBCPP adopted by its parent company
- (2) a small company incorporates the TQPP into a multi-companies DBCPP

I will show each example of them, and then I will explain the characteristics of Company-Group DB Pension Plan.

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\* In fact, many small companies in Japan have converted the TQPP to the Smaller Enterprise Retirement Allowance Mutual Aid (SERAMA), which we call "Chutaikyo" in Japanese. I do not consider SERAMA in this paper because it is a governmental pension scheme and there are several conditions for participating in it (For example, in case of manufacturing company, the number of employees must not be more than 300).



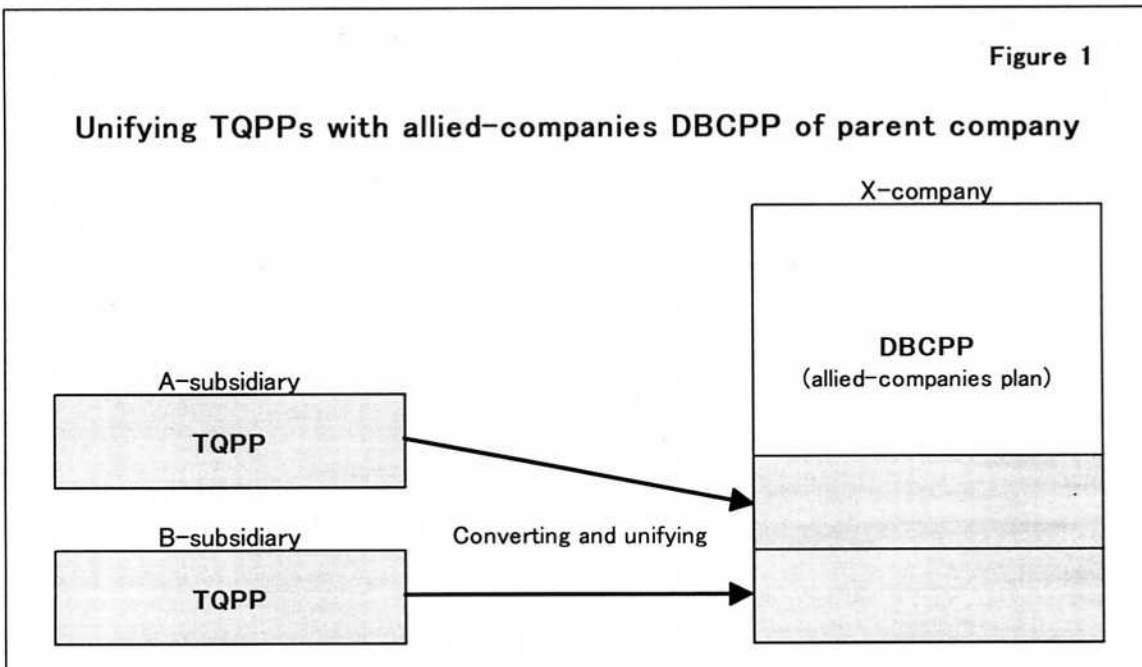
## 2. Examples of Company-Group DB Pension Plan

### 2.1 Unifying TQPP with allied-companies DBCPP of the parent company

X-company is one of the largest electric manufacturers in Japan. It has about one thousand subsidiaries and its company group is doing business in various fields from social infrastructure to home appliances, materials, logistics, service, and so on.

Many of the subsidiaries of X-company adopted TQPP. X-company considered how its subsidiaries could continue their DB type pension plan and how it could cut down the Projected Benefit Obligation (PBO) for consolidated accounting.

X-company planned that its subsidiaries would convert TQPP to the allied-companies DBCPP of X-company and unify them (See Figure 1). It has unified about 120 TQPPs within only 2 years. The number of participants has increased from 56,000 to 102,000. The amount of pension fund has increased from 450 billion yen to 600 billion yen.



The main features of this scheme are as follows:

#### (1) Efficient operation of pension plan

As many corporate pension plans of the subsidiaries have been integrated into the allied-companies DBCPP of X-company, it has become more efficient to manage the pension fund. Besides, the subsidiaries can cut down on the administrative expense of their pension plans.

(2) Portability in the company group

Before the unification, if employees transferred to another company in X-company group, they could not necessarily carry their pension benefit rights to their new plan. But now they can still belong to their pension plan as long as they move to the company adopting the allied-companies DBCPP. As a result, they can expect enough pension benefit when they retire. The pension portability also helps X-company to reorganize its business in the group.

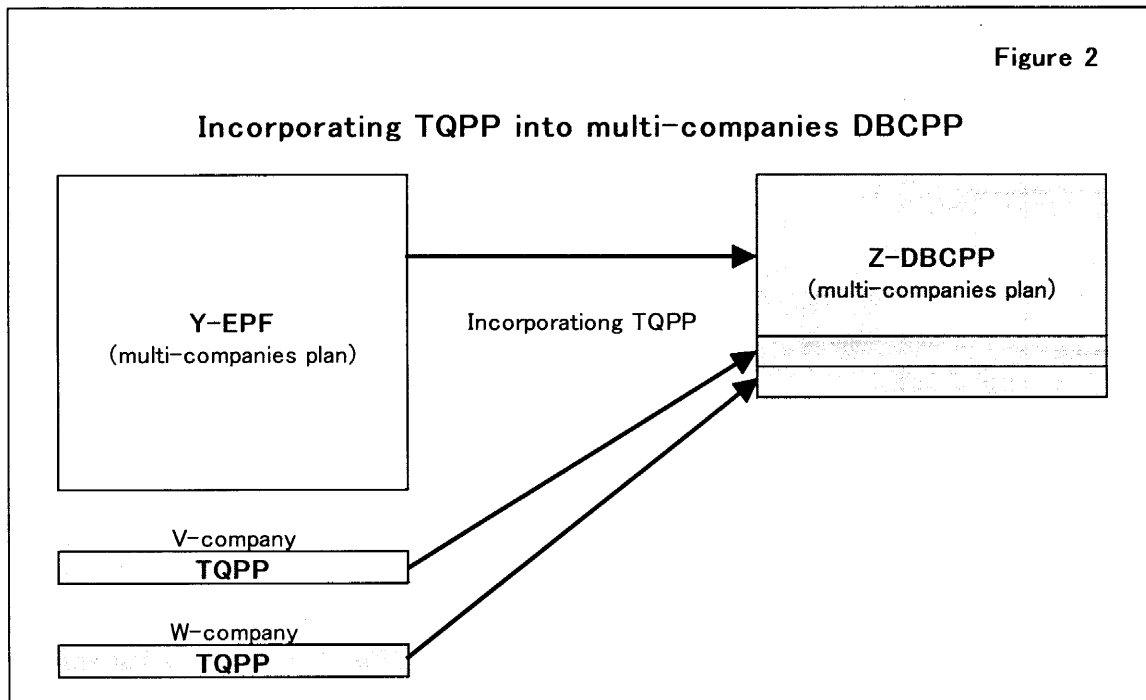
(3) Reduction of PBO

The benefit of the DBCPP is based on Cash Balance Plan (CBP). The conversion rate of interest becomes lower in proportion to the recent decline of government bond rate. Therefore, X-company can reduce the PBO for consolidated accounting because of the lower benefit expense.

Incidentally, X-company group has also unified the book-reserved lump-sum benefit system and the Defined Contribution (DC) pension plan.

2.2 Incorporating TQPP into multi-companies DBCPP

Y-EPF is the multi-companies EPF which consists of about 300 truck transportation companies in K-prefecture. About 10 percent of the member companies have TQPP and the number of the TQPPs' participants is about 3,000. Therefore, Y-EPF judged that it was possible to manage a multi-companies DBCPP which consists of the TQPPs' participants. And it decided to establish the multi-companies DBCPP (named Z-DBCPP) so that the member companies could incorporate their TQPP into it (See Figure 2).



Z-DBCPP can accept not only member companies of Y-EPPF but also other truck transportation companies all over Japan. The office of Y-EPPF does administration of Z-DBCPP because it has a lot of know-how to manage a multi-companies pension plan.

Z-DBCPP has adopted CBP for stable financial management. The CBP has two main characteristics. First, the pay credit of the CBP is fixed, not related with earnings, because wage system varies from one company to another. Second, the member companies can decide the amount of pay credit because desirable amount of pension benefit differs among the member companies.

Now Z-DBCPP has only 13 member companies located in K-prefecture. In order to increase the members, more advertisement about the plan is necessary. We can expect that Z-DBCPP will develop into a nationwide multi-companies DBCPP in the future.

### 3. Advantages of Company-Group DB Pension Plan

I have viewed some examples of Company-Group DB Pension Plan in Japan, including the two examples mentioned above. As a result, I have found three main advantages. They are as follows:

- (1) Scale merit stabilizing finance
- (2) System unification making simplicity
- (3) Portability of benefit rights

#### 3.1 Scale merit stabilizing finance

Company-Group DB Pension Plan is such a large pension plan that the scale merit can stabilize the finance.

Scale merit can disperse default risk of a small pension plan. For example, see Figure 3. C-company is a small company and the funding rate of its DB pension plan is only 30%. The financing is not stable and the amortization cost per year is 14 (not consider interest for amortization; the cost = net liability/ amortization period =  $70/5 = 14$ ).

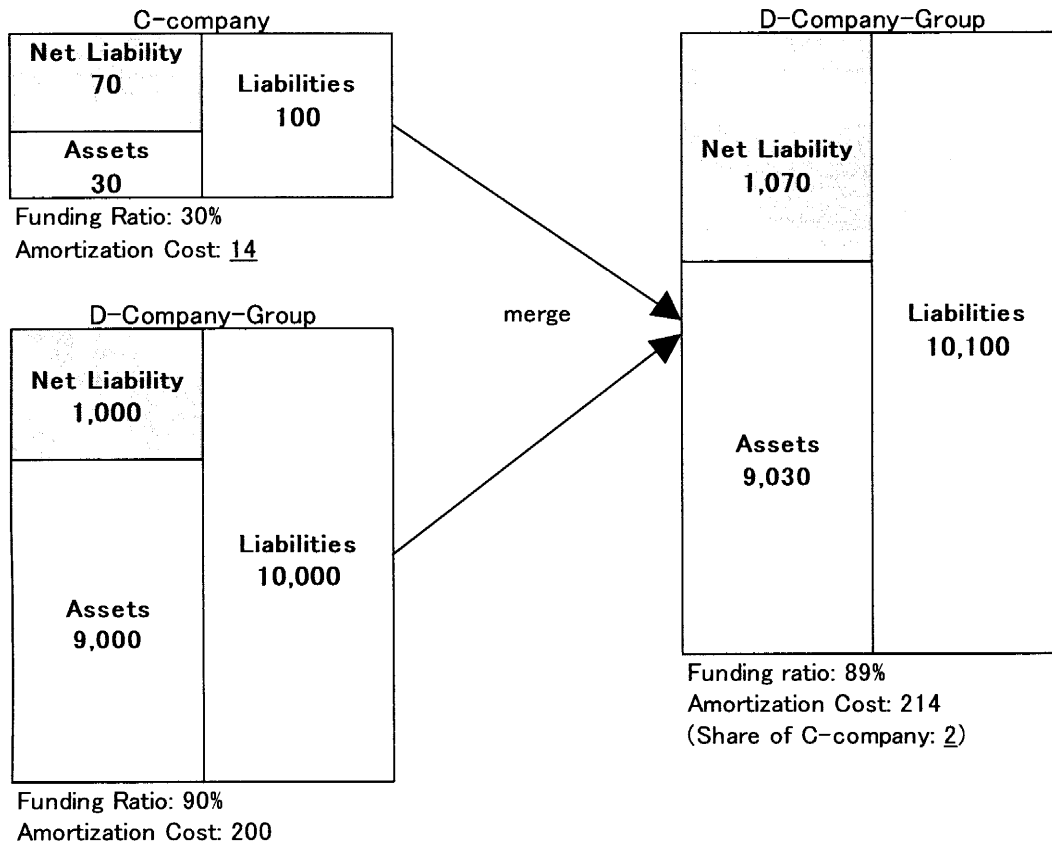
If C-company's plan merges with D-Company-Group DB pension plan, what will happen? D-Company-Group plan is a large and stable plan (the amount of assets is 9,000 and the funding rate is 90%). After the merger, the stability of D-Company-Group plan hardly changes (the funding rate is 89%). And the amortization cost of C-company decreases to only 2 (total amortization cost =  $1,070/5 = 214$ , and cost share is proportional to amount of liabilities;  $214 * (100/10,100) = 2$ ).

Scale merit can also make the pension fund management more efficient as mentioned in the example of X-company. The expense of investment can decrease. And as the amount of pension fund gets larger, more effective investment becomes available, namely, the risk tolerance gets higher, the cash flow is put together, and the diversified investment effect gets larger.



Figure 3

Risk dispersion by scale merit of pension plan



[Condition]  
 Amortization period for net liability: 5 years  
 (No consideration about interest for amortization)  
 Cost share is proportional to amount of liabilities

Besides, CBP helps the pension financial management to be more stable. The plans have enormous amount of pension fund, and so CBP is effective to control the risk caused by change of interest rate. In fact, most of the Company-Group DB Pension Plans in Japan adopt CBP.

3.2 System unification making simplicity

Company-Group DB Pension Plan unifies various DB pension systems of the member companies and that can make their pension systems simple and understandable.



Company-Group DB Pension Plan may include hundreds or thousands of companies and there is only one pension system for them. If the member companies have their pension system individually, the pension management will be very complicated and there will be a lot of office tasks. But Company-Group DB Pension Plan is managed by the common system among the members and that makes the pension administration simpler and easier.

Company-Group DB Pension Plan has the headquarters (HQ) for the entire group, such as pension committee. The HQ grasps all the pension information of the member companies and works out a pension management strategy for the company group. And it has the only one administrative office as the subordinate organization, which deal with all the office tasks of the pension plan. Therefore, the amount of administrative expense decreases considerably.

Although Company-Group DB Pension Plan has a unique pension benefit system, desirable amount of benefit for the member companies varies from company to company. So it is necessary to conform to their needs.

In the case of "allied-companies DBCPP of the parent company", many Company-Group plans adopt points basis benefit formula. Points can be allocated according to employee ranks of each company and it is possible to adjust points to retirement benefit. (See Table 1. Retirement (at age 60) benefit of E-company is 1,000 and that of F-company is about 500.)

In the case of "multi-companies DBCPP", many Company-Group plans adopt CBP with fixed pay credit and the member companies can choose the amount of pay credit (as mentioned in the example of Z-DBCPP). The pension benefit formula should be common among hundreds or thousands of companies, so the CBP should not be related with earnings. And the member company can choose the amount of pay credit according to their desirable retirement benefit.

(See Table 2. If a company needs 6,000,000 retirement benefit per employee, it must choose 6,526 pay credit per month.)





Table 1

Examples of retirement benefit on points basis

Points system of E-company

Points table	
Rank	Point
E-1	10
E-2	13
E-3	17
E-4	30
E-5	40
E-6	50

Benefit model		
Age	Rank	Benefit
22	E-1	0
23	E-1	10
24	E-1	20
25	E-1	30
26	E-1	40
27	E-2	50
28	E-2	63
29	E-2	76
30	E-2	89
31	E-2	102
32	E-2	115
33	E-2	128
34	E-3	141
35	E-3	158
36	E-3	175
37	E-3	192
38	E-3	209
39	E-3	226
40	E-3	243
41	E-4	260
42	E-4	290
43	E-4	320
44	E-4	350
45	E-4	380
46	E-4	410
47	E-4	440
48	E-5	470
49	E-5	510
50	E-5	550
51	E-5	590
52	E-5	630
53	E-5	670
54	E-5	710
55	E-6	750
56	E-6	800
57	E-6	850
58	E-6	900
59	E-6	950
60	E-6	1,000

Points system of F-company

Points table	
Rank	Point
F-1	5
F-2	10
F-3	16
F-4	22

Benefit model		
Age	Rank	Benefit
22	F-1	0
23	F-1	5
24	F-1	10
25	F-1	15
26	F-1	20
27	F-1	25
28	F-1	30
29	F-1	35
30	F-1	40
31	F-2	45
32	F-2	55
33	F-2	65
34	F-2	75
35	F-2	85
36	F-2	95
37	F-2	105
38	F-2	115
39	F-2	125
40	F-2	135
41	F-3	145
42	F-3	161
43	F-3	177
44	F-3	193
45	F-3	209
46	F-3	225
47	F-3	241
48	F-3	257
49	F-3	273
50	F-3	289
51	F-4	305
52	F-4	327
53	F-4	349
54	F-4	371
55	F-4	393
56	F-4	415
57	F-4	437
58	F-4	459
59	F-4	481
60	F-4	503





Table 2

**Choice of fixed pay credits of CBP**

Retirement benefit	3,000,000	6,000,000	9,000,000	12,000,000
Pay credit/Month	3,263	6,526	9,788	13,051

[Condition]

Participation Age: 20

Retirement Age: 60

Interest rate: 3% per year

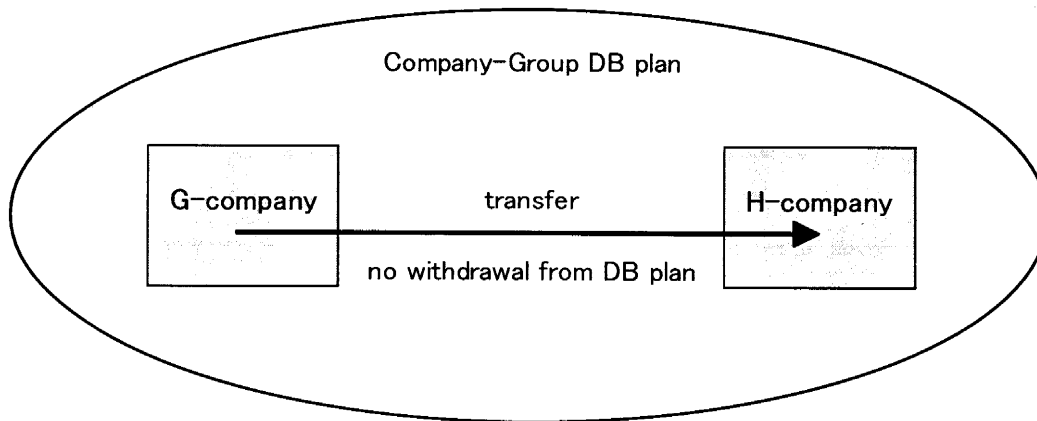
Benefit = Hypothetical account balance

**3.3 Portability of benefit rights**

If participants of Company-Group DB Pension Plan transfer to another company which belongs to the plan, they do not have to withdraw from the plan (See Figure 4). Therefore, they can stay in the plan long enough to receive large amount of pension benefit even after transfer.

Figure 4

**Image of pension portability**



Pension portability fits the recent trend of forming holding companies in Japan. Nowadays, business situation changes so rapidly that companies may have to reorganize their business rapidly in order to keep up with the changes. For that, formation of holding company is effective. When a holding company

reorganizes its subsidiaries, many of the employees will transfer to another subsidiary. Therefore, pension portability will be indispensable for the holding company.

Pension portability also fits mobility of labor. In the example of Z-DBCPP, if a truck driver changes his truck transportation company and both new and old companies of him participate in Z-DBCPP, he does not have to withdraw from the pension plan (As shown in Figure 4).

And ultimately, Company-Group DB Pension Plan brings about a sense of togetherness and security among the member companies.

#### **4. Problems of Company-Group DB Pension Plan in Japan and solutions**

In Japan, there are a lot of large companies (mainly manufacturing companies) which adapt allied-companies DB pension plan. But more large companies should adapt it, because the scheme helps company-groups to reorganize their business according to rapid business situation changes, as mentioned above.

In order to promote allied-companies DB pension plan among large companies, the large companies should have strong initiative enough to proceed the plan unification with their subsidiaries smoothly. And technical assistance of the specialist, such as pension consulting company, is also necessary.

In regard to multi-companies DB Pension Plan, there are only a few multi-companies DBCPPs so far \*. There is no clear regulation for them. Therefore, it is not well-known in corporate pension business. But it can be effective way for small companies which do not have large parent company to continue the DB type pension plan.

To establish a substantial multi-companies DBCPP, the organization base must have strong leadership and control. Because there should be many participants enough to manage pension finance stably. And, the government should advertise multi-companies DBCPP more and provide regulations to promote the establishment. At the same time, the trustee companies should introduce prospective new members to the DBCPP.

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\* Some companies convert the TQPP to the second supplementary portion of the multi-companies EPF they are attached to. This is also a kind of multi-companies DB Pension Plan. However, in this scheme, there are some disadvantages such as (1) the benefit design must adjust to that of the EPF, (2) only the EPF member companies can do, and (3) the whole system of the EPF becomes more complicated. Therefore, multi-companies DBCPP can be more flexible and simpler.



## 5. Conclusions

As aged people are increasing in society, DB pension recipients are also increasing and pension liabilities are getting larger. In addition to that, recent worldwide economic recession caused stock prices plunge and DB pension funds deteriorated terribly. As a result, management of DB plan is becoming a heavy burden for the employer.

However, DB type pension plan is a safe system for the employees' security in their old age. It can be an incentive to work hard for their company, too. And so, it should survive permanently.

In this paper, I have mentioned Company-Group DB Pension Plan as one effective means of continuing DB plan in Japan where TQPP will be abolished and it is a serious problem how small companies can continue their DB type pension plan.

There are two main types of Company-Group DB Pension Plan, namely, allied-companies DB pension plan managed by a large company and multi-companies DB pension plan. In case of company which is a subsidiary of a large company, allied-companies DB pension plan scheme is effective. In case of the other company, multi-companies DB pension plan scheme is effective.

Company-Group DB Pension Plan has three main advantages: (1) Scale merit stabilizing finance, (2) System unification making simplicity, and (3) Portability of benefit rights. Although it is not popular enough in Japanese corporate pension business, it has the potential to develop in the future.

I believe that Company-Group DB Pension Plan can be an effective scheme all over the world. I am happy if this paper will contribute to survival of DB type pension plan.



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