

International Conference on Annuities Markets: Structure, Trends and Innovations

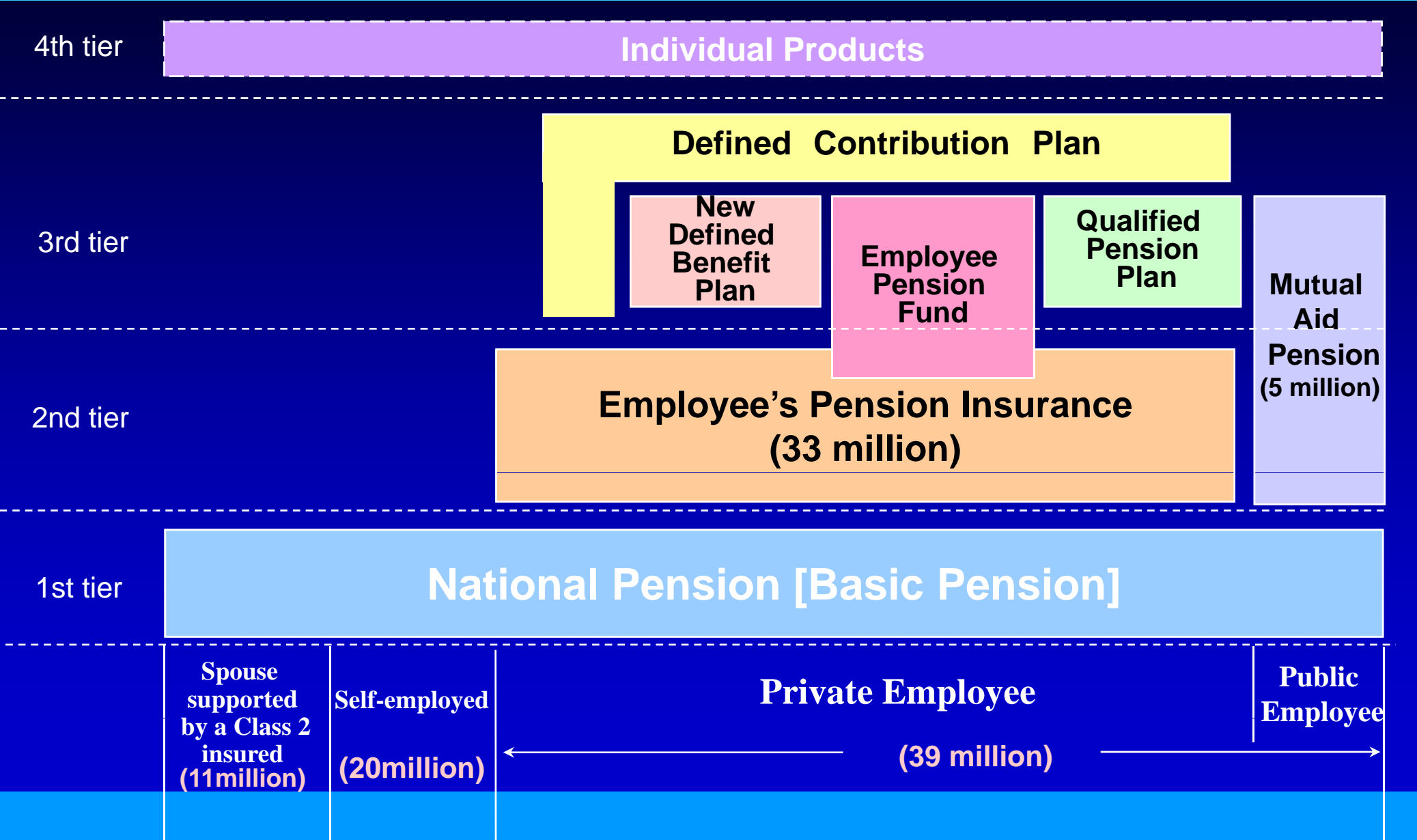
Experiences in Japan

January 30, 2009

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Consultant
Towers Perrin Tokyo



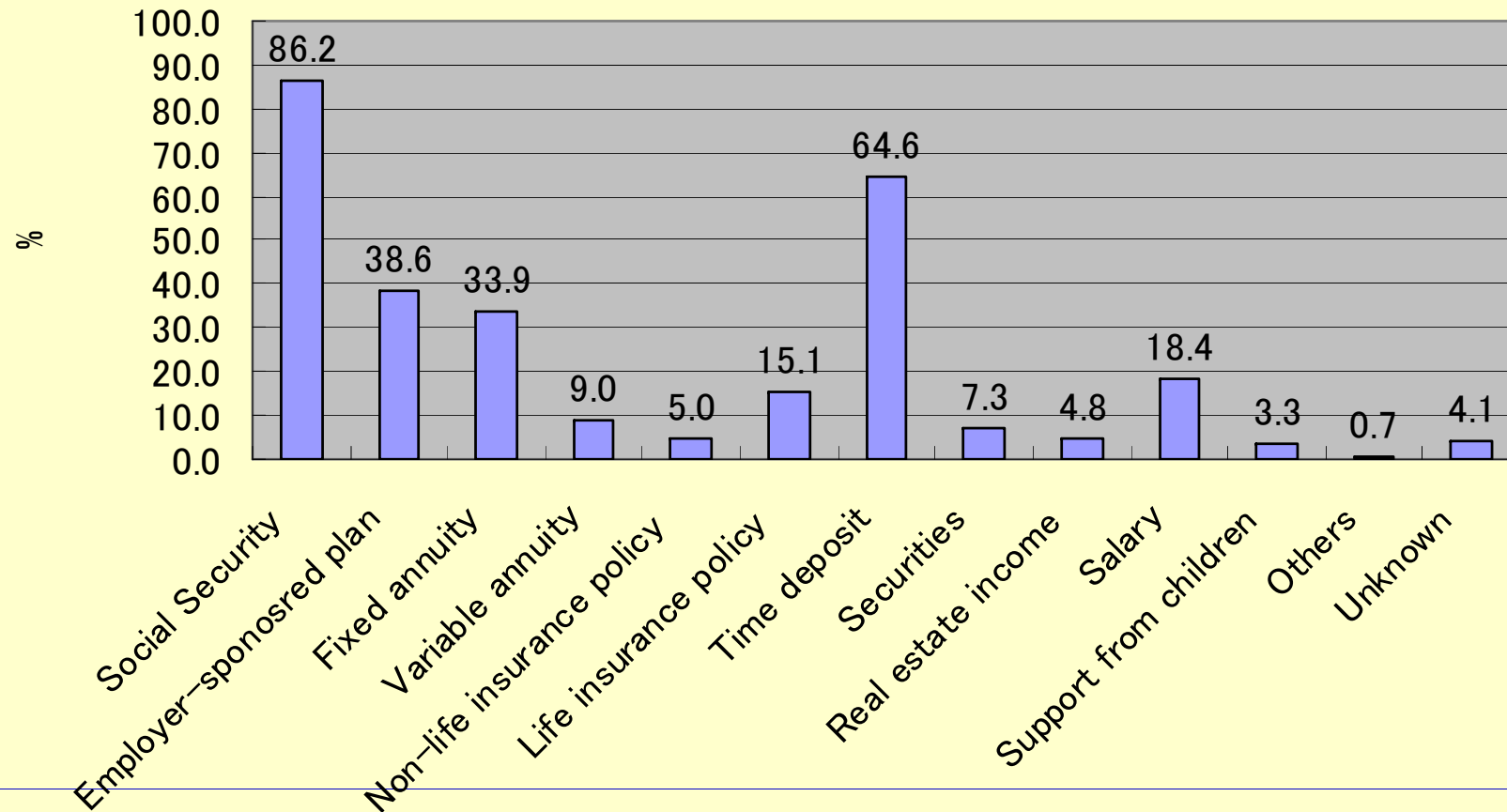
Japanese pension system



Retirement income resources for Japanese

Means for Retirement Income

(Percentage of people answered "yes")



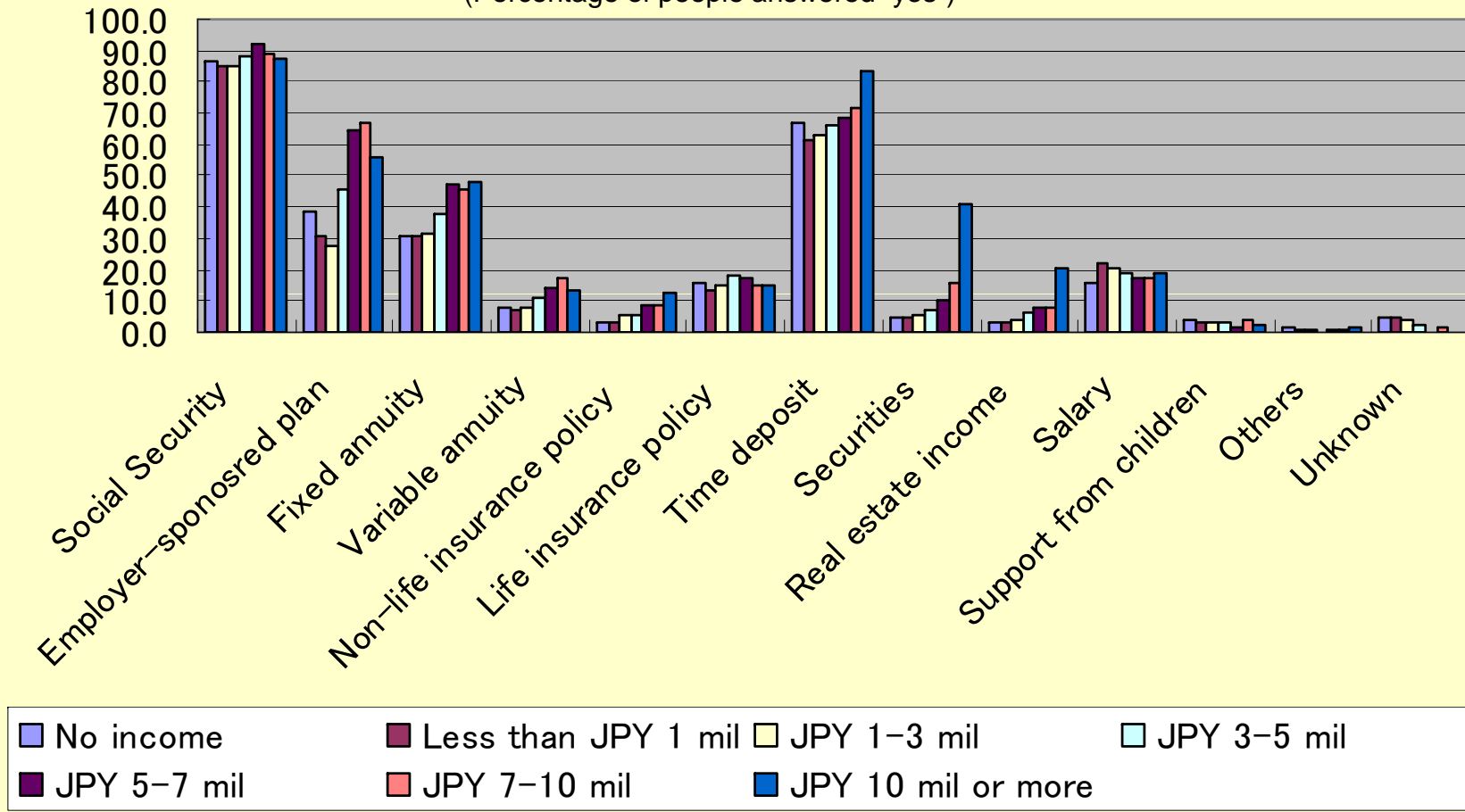
N=4059

Data Source: Japan Institute for Life Insurance

Retirement income resources by annual income

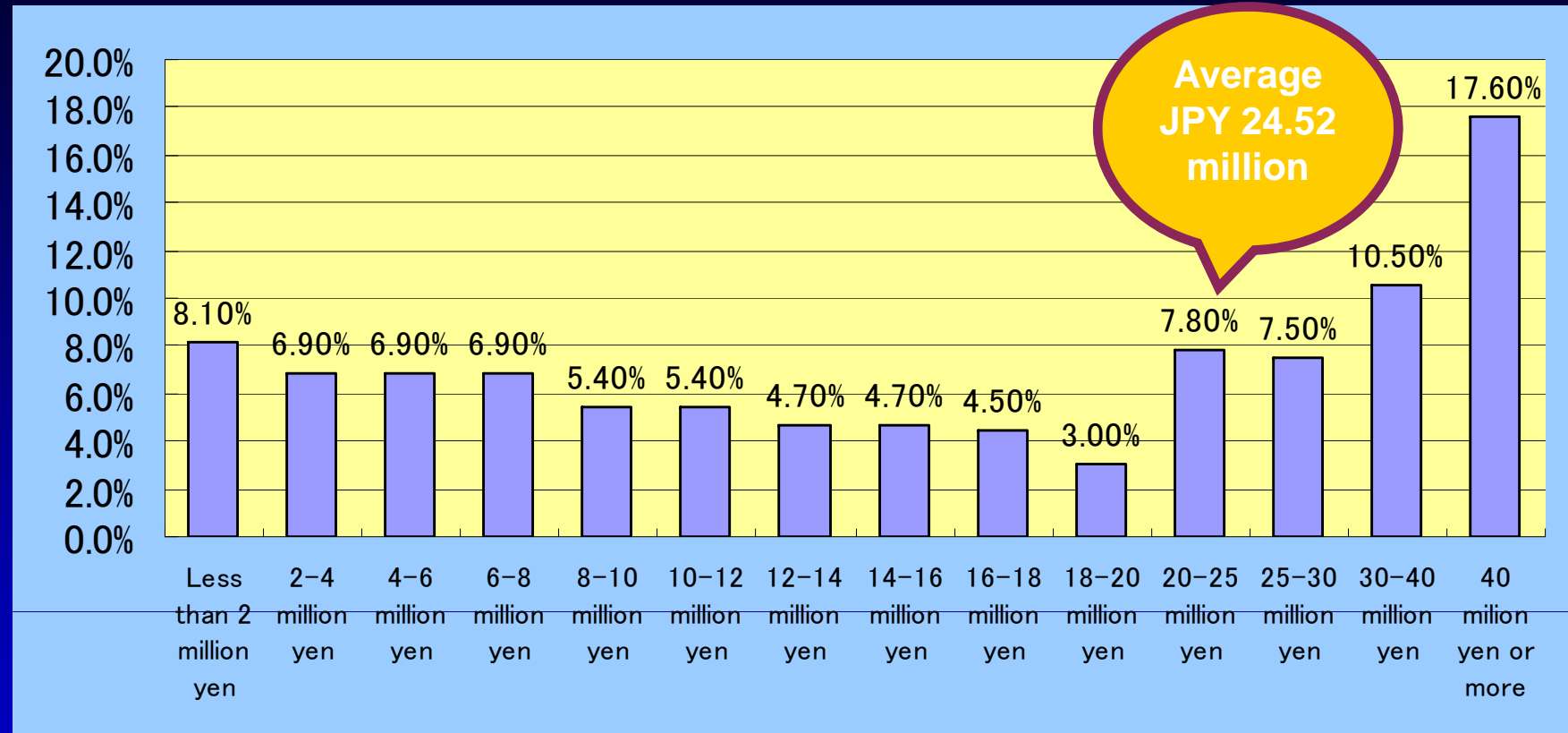
Means for Retirement Income by Current Annual Income

(Percentage of people answered "yes")



N=3196 Data Source: Japan Institute for Life Insurance

Distribution of Savings Amount for Age 60 or over



Data Source: Ministry of Internal Affairs and Communications

Allocation of savings

	Bank deposit	Insurance	Securities	Others
60's	56%	23%	18%	2%
70's	58%	17%	23%	2%

Data Source: The Central Council of Financial Services Information

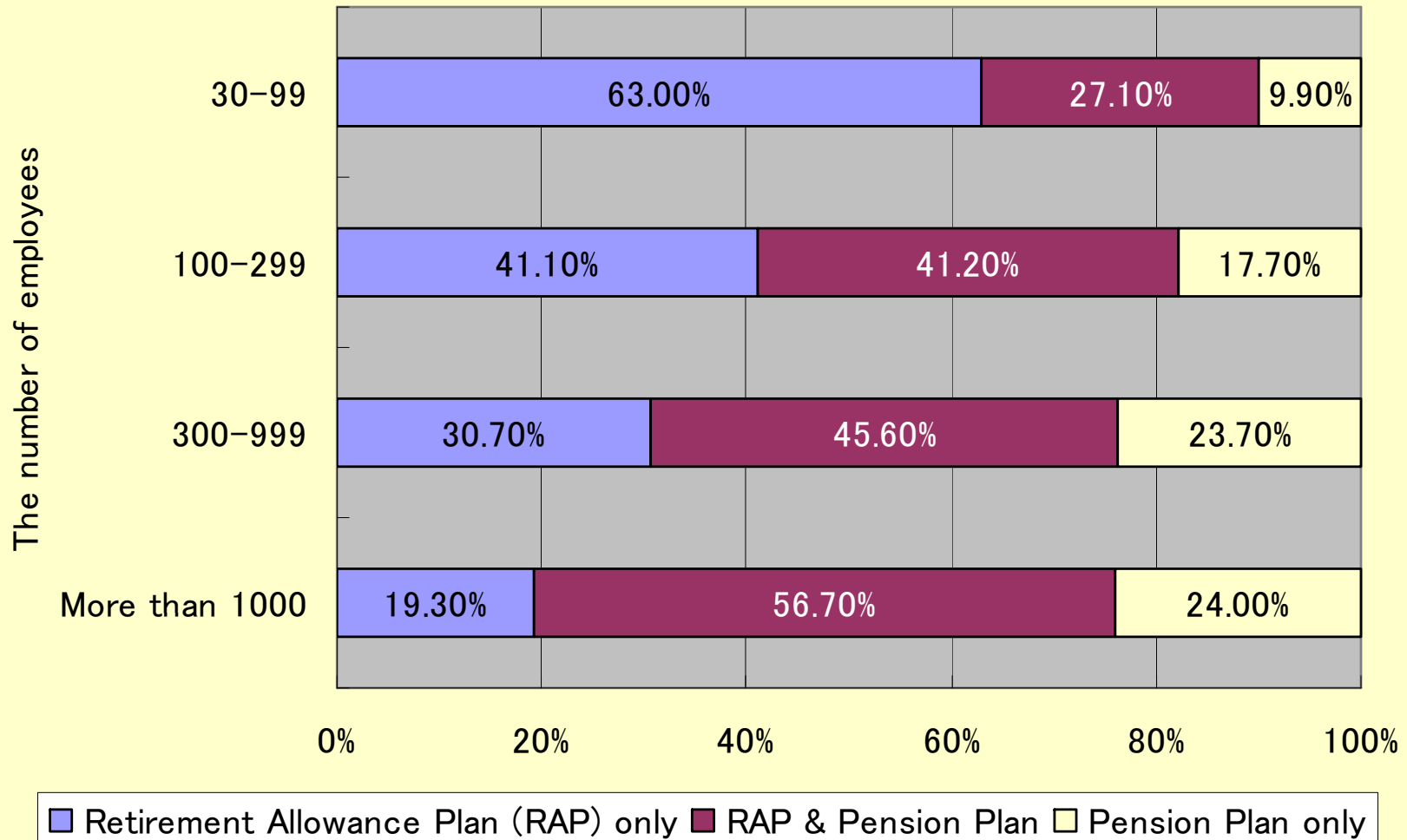
Tier 3: Employer-sponsored Retirement Plans



Employer-sponsored retirement plans

- Lump Sum Plan (Retirement Allowance Plan) vs. Pension Plan

Employer-Sponsored Retirement Plans by Size

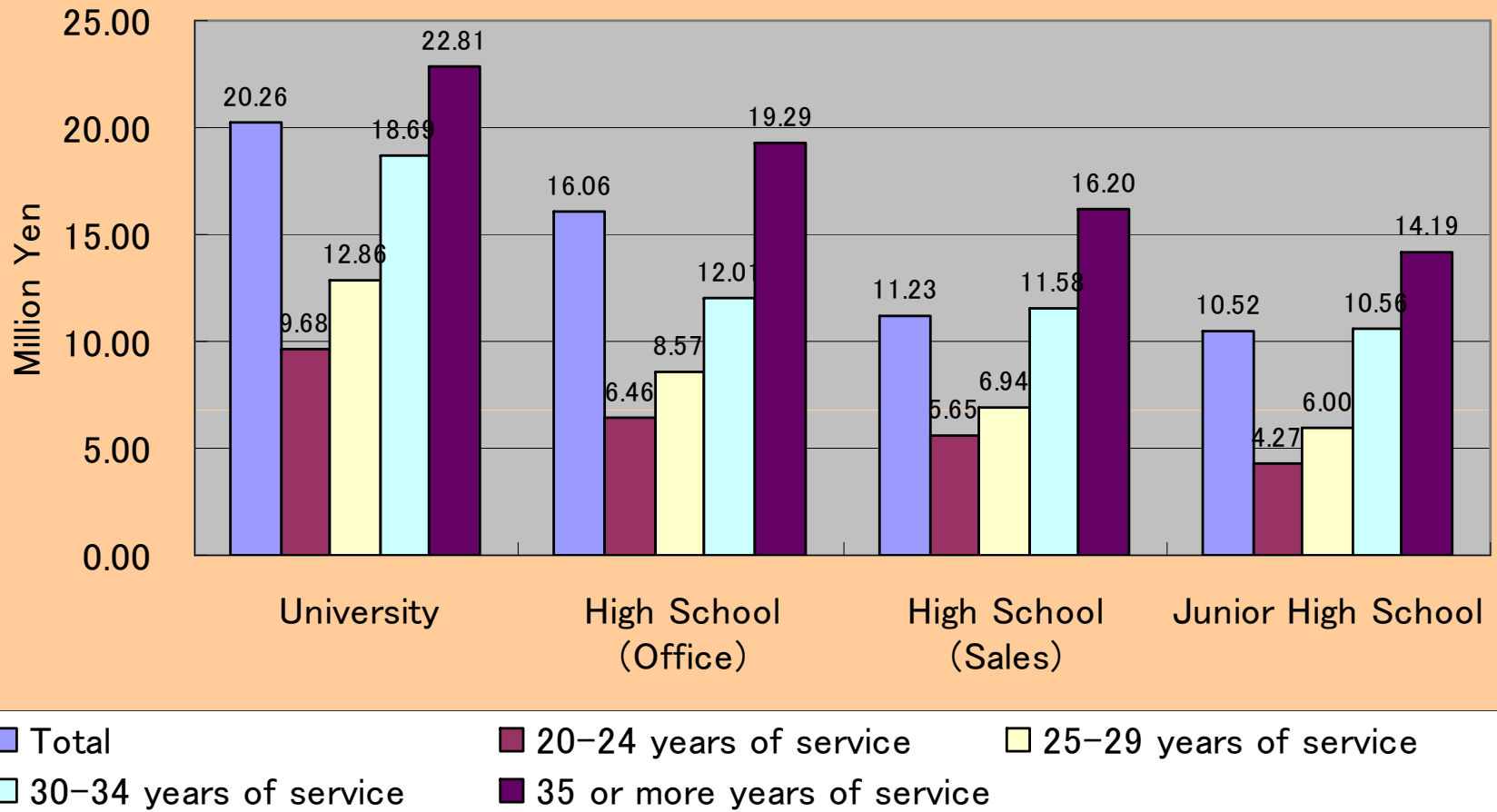


Data Source: Ministry of Health, Labour, and Welfare

Average lump sum value of employer-sponsored retirement plans

Average Lump Sum Value at Age 60 from Employer-Sponsored Plans by Education Background

The following data is based on those who worked for 20 years or more and whose age is 45 years old or more



Employer-sponsored pension plans

Evolution of Pension Plan Legislation in Japan

1962: Qualified Pension Plans (QPP)

End: March 31, 2012

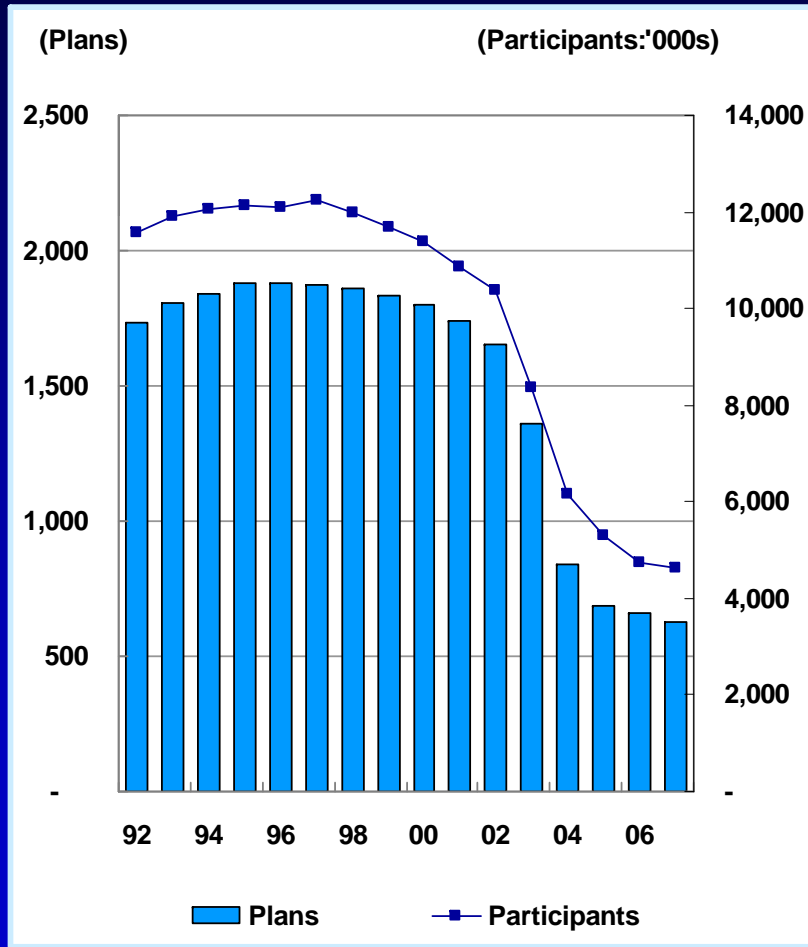
1966: Employee Pension Fund (EPF)

October 2001: Defined
Contribution Pension (DC)

April 2002: Defined Benefit
Corporate Pension Plan (New DB)

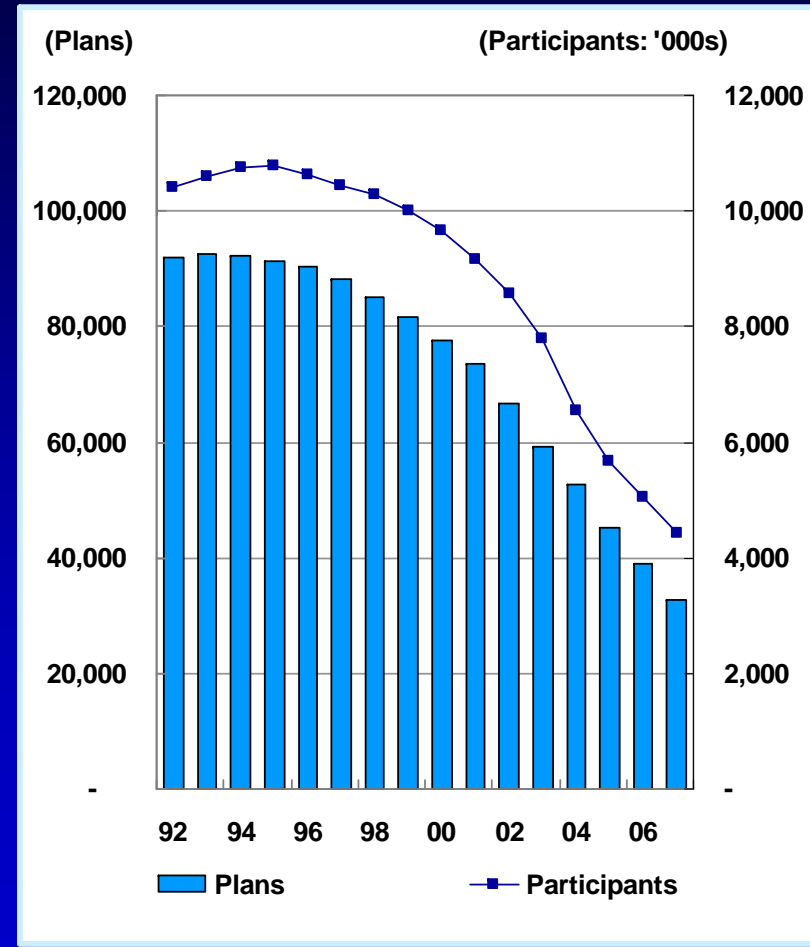
Market trend in employer-sponsored pension plans

EPFs – Number and Plan Participants



Asset size as of March 2007: JPY 20.5 trillion

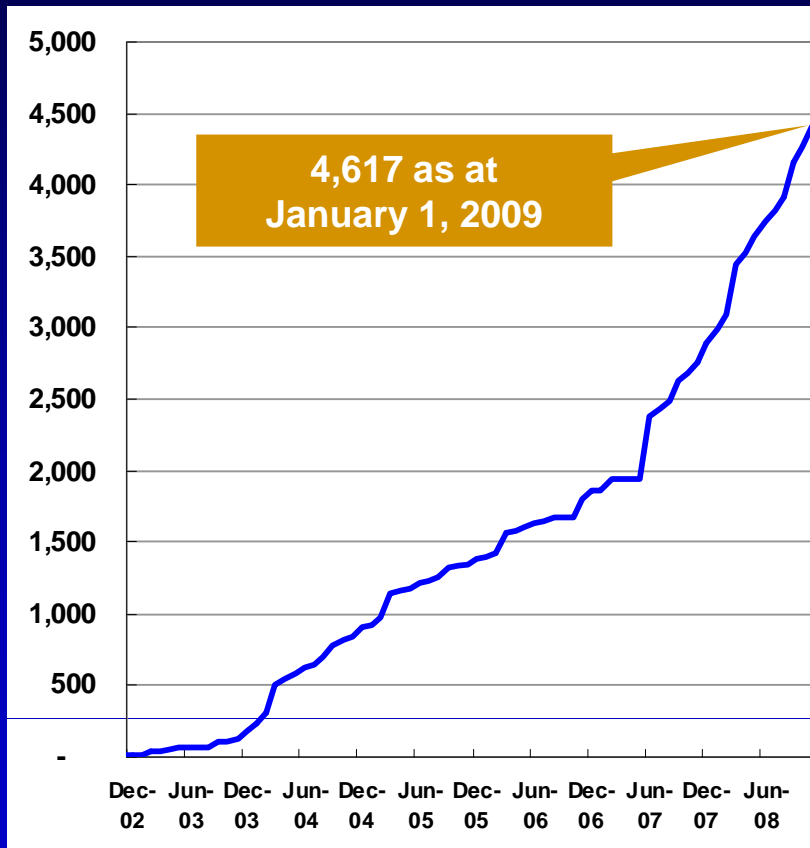
QPPs – Number and Plan Participants



Asset size as of March 2007: JPY 11.7 trillion

Market trend in employer-sponsored pension plans

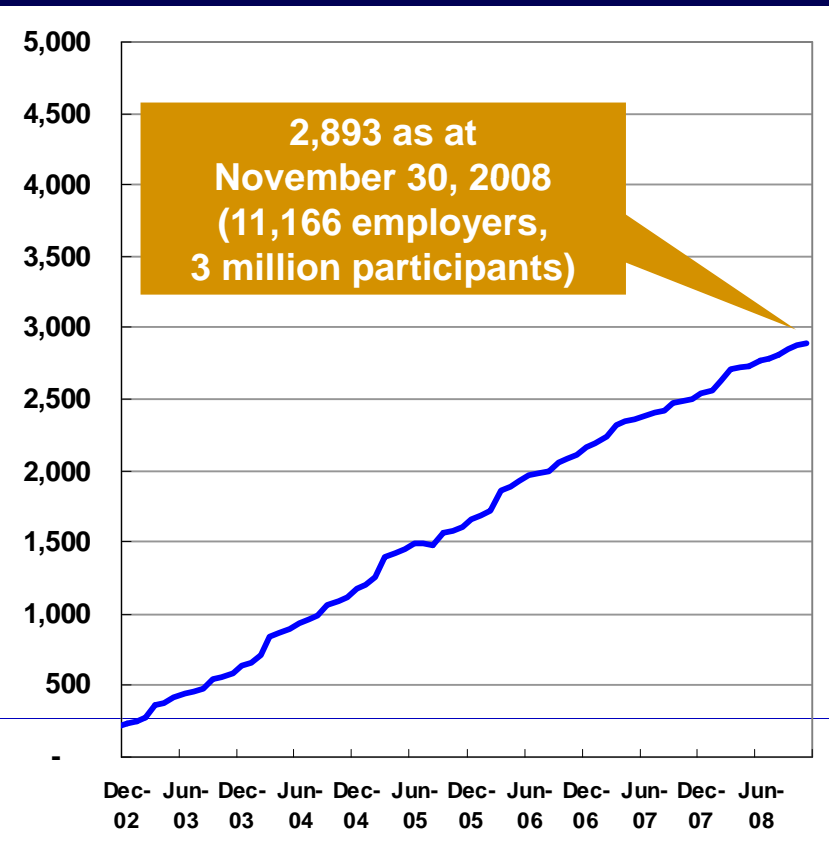
Growth in New DB Plan Market



— Number of New DB Plans

Asset size as of March 2007: JPY 22.2 trillion

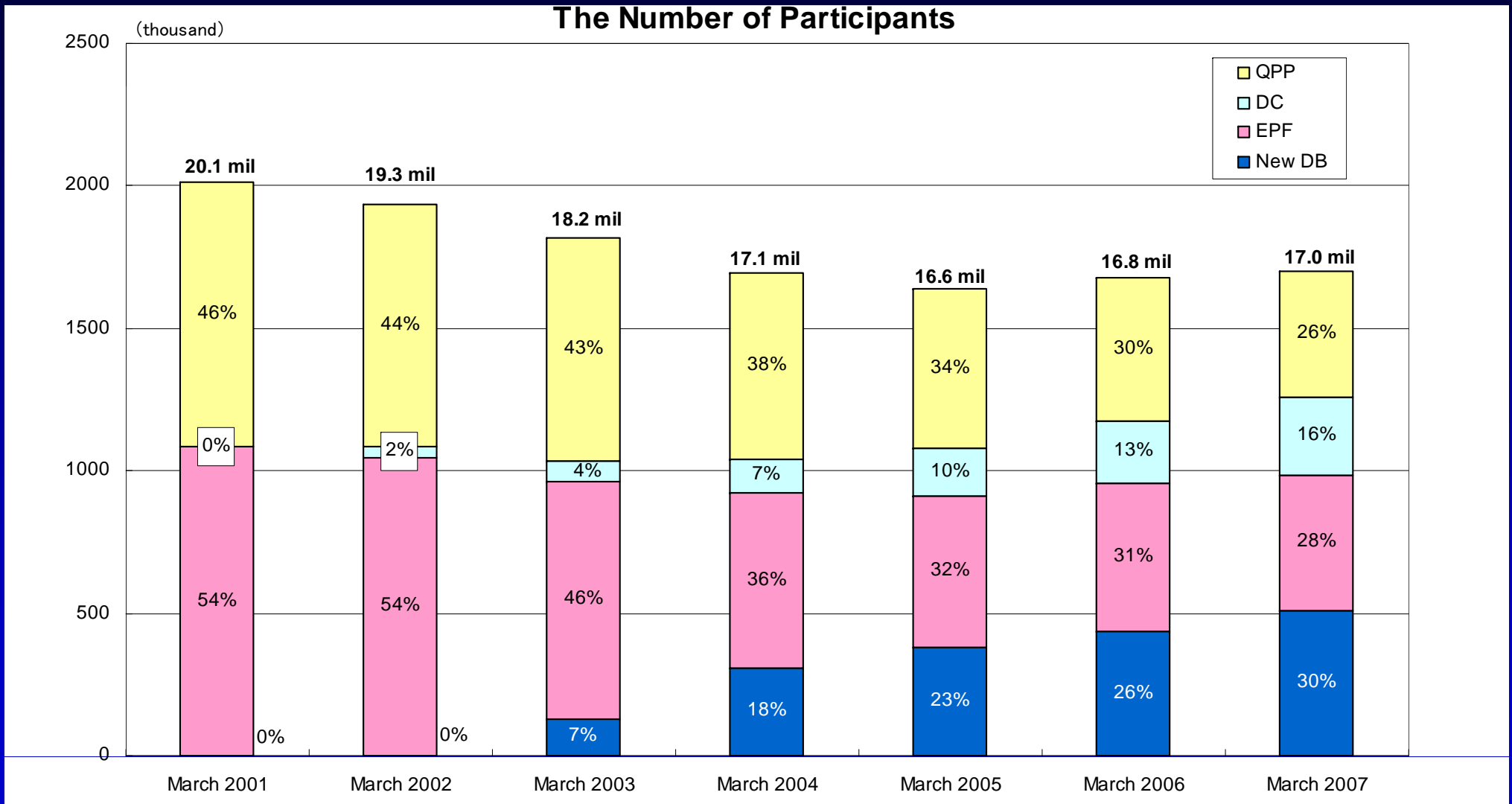
Growth in New DC Plan Market



— Number of DC Plans

Asset size as of March 2007: JPY 3.7 trillion

Trend of participants in employer-sponsored plans



Regulations for forms of benefit payments in pension plans

■ Qualified Pension Plans (QPP)

- No specific regulations
- Typical eligibility:
 - One to three years of service for lump sum payment
 - 15 to 20 years of service (and attainment of age 60) for annuity payments
 - 10-year certain annuities are most popular design
 - Life annuities are not necessary required
 - Participants can choose lump sum instead of annuities

■ Employee Pension Funds (EPF)

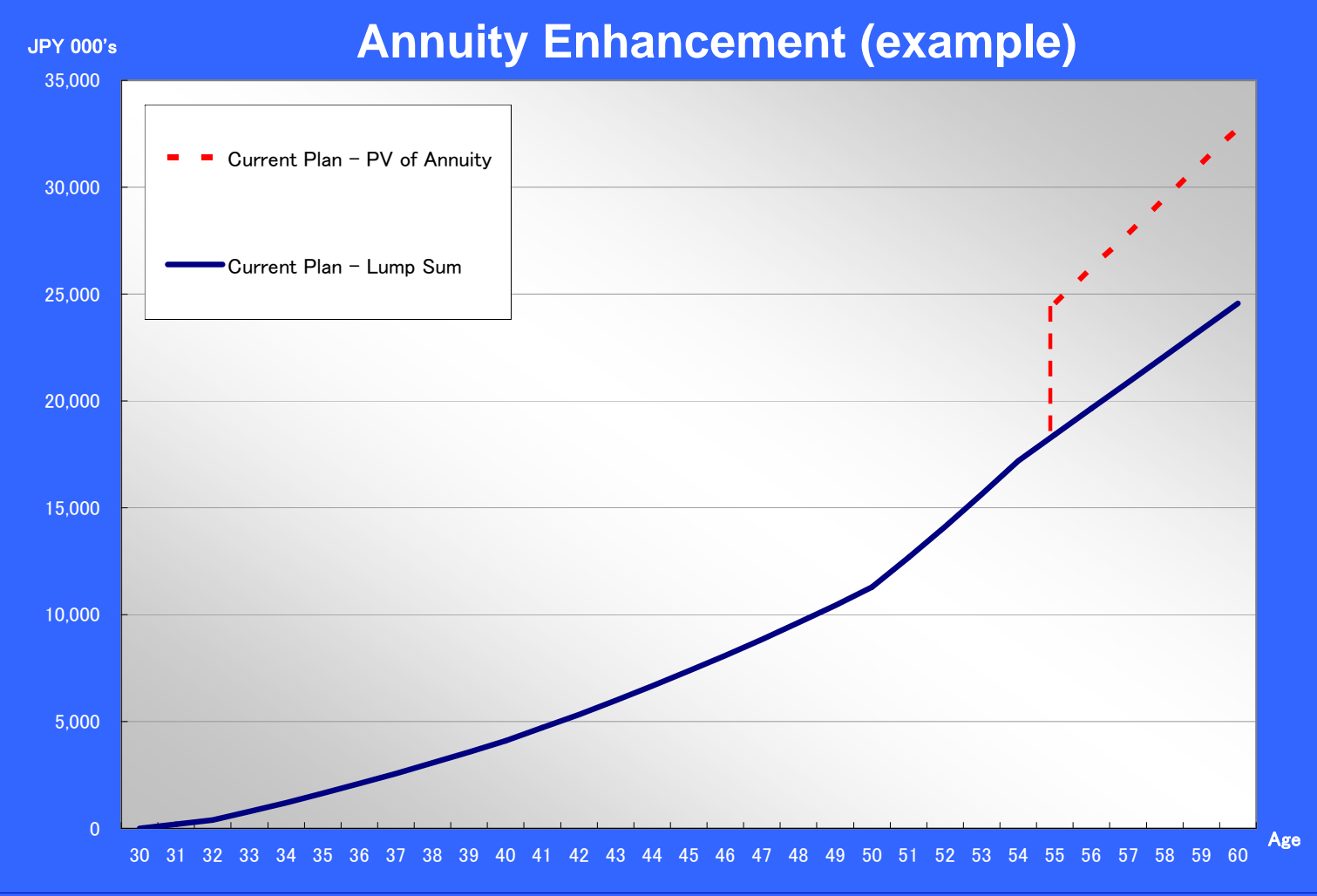
- Lump sum payments must be provided for those who have participated in EPFs for at least three years
- Annuity payments must be provided for those who have participated in EPFs for at least 20 years
 - Life annuities must be one of the options
 - Participants can choose lump sum instead of annuities

Regulations for forms of benefit payments in pension plans

- **New Defined Benefit Corporate Pension Plans (New DB)**
 - Lump sum payments must be provided for those who have participated in New DB for at least three years
 - Annuity payments must be provided for those who have participated in New DB for at least 20 years
 - Life annuities are not necessarily required
 - Participants can choose lump sum instead of annuities

- **Defined Contribution Plans (DC)**
 - Annuities (at least five-year certain annuities) must be provided
 - Lump sum payments can be provided as an option
 - Benefits can be received only after participants reach age 60

Present value of annuities is higher than lump sum value due to high annuity conversion rate (5.5% for most QPPs)

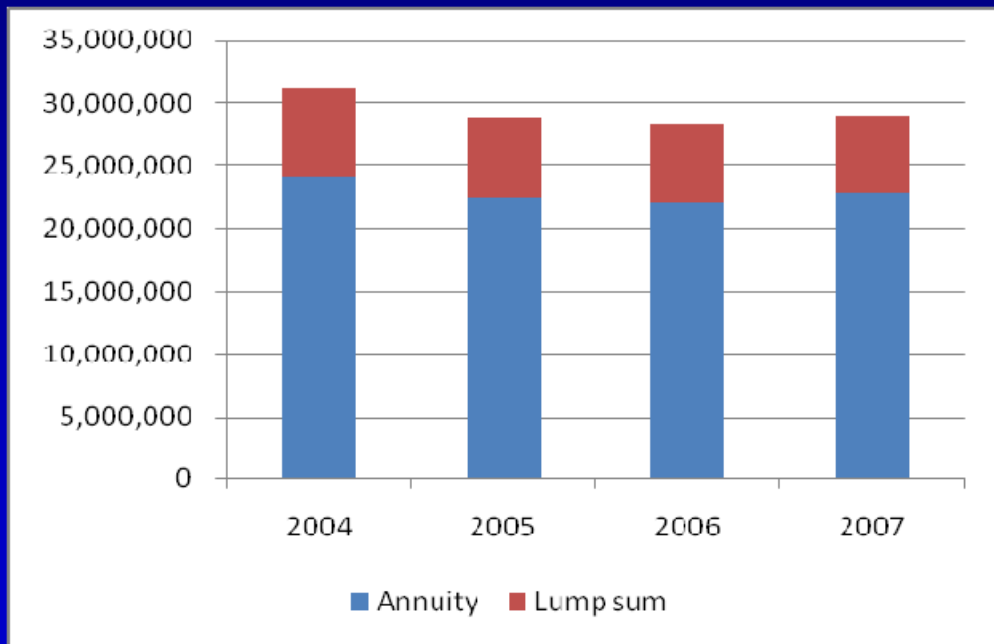


Still, more people choose lump sum payments...

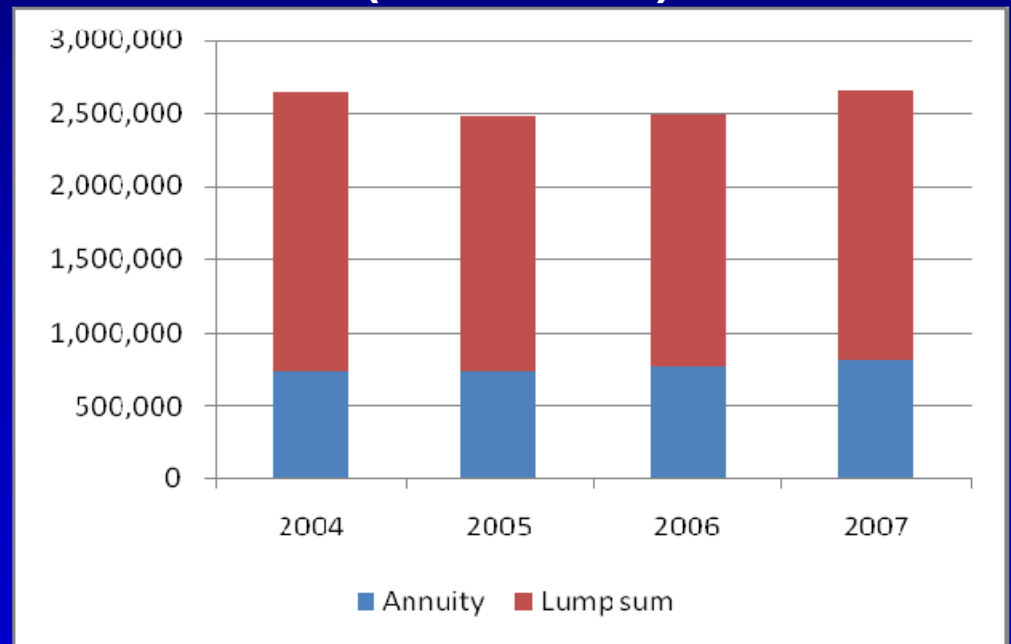
Form of payments in employer-sponsored pension plans

- Participants in employer-sponsored pension plans tend to receive benefits in the form of lump sum more than in the form of annuities.

The Number of Cases Paid



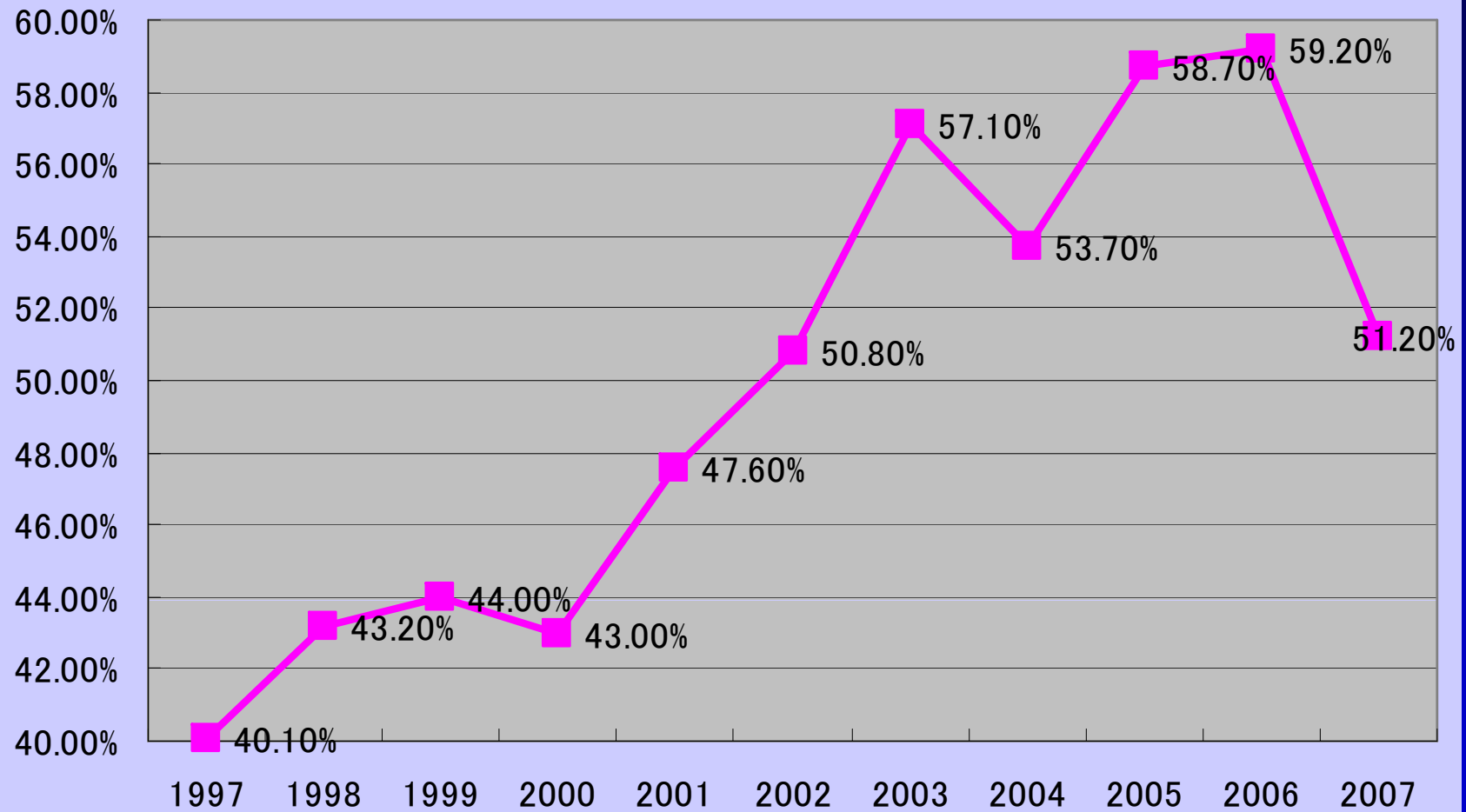
The Amount of Payments (Million Yen)



Data source: Life Insurance Association of Japan

Selection ratio of lump sum in EPF

Ratio of Lump Sum Selection in EPF



Data source: Pension Fund Association

Average monthly amount of annuity payments

EPF: As more and more larger companies have switched from EPF to New DB in the last seven years, average amount for monthly annuity payment has decreased.

2002	2007
JPY 51,143	JPY 38,229

New DB: Close to the amount of EPF in 2002

July, 2008
JPY 64,400

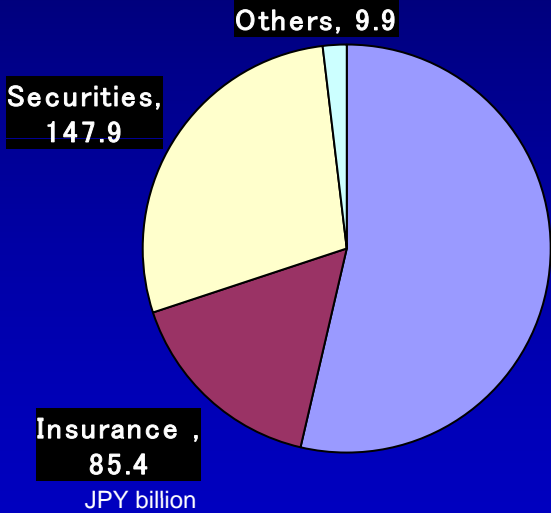
QPP: Amounts tend to be larger than EPF and New DB mainly because only those who reach age 60 (or 50, 55) can receive annuities in QPPs

2007
JPY 98,350

Asset allocation of DC plans

March 2008

March 2004

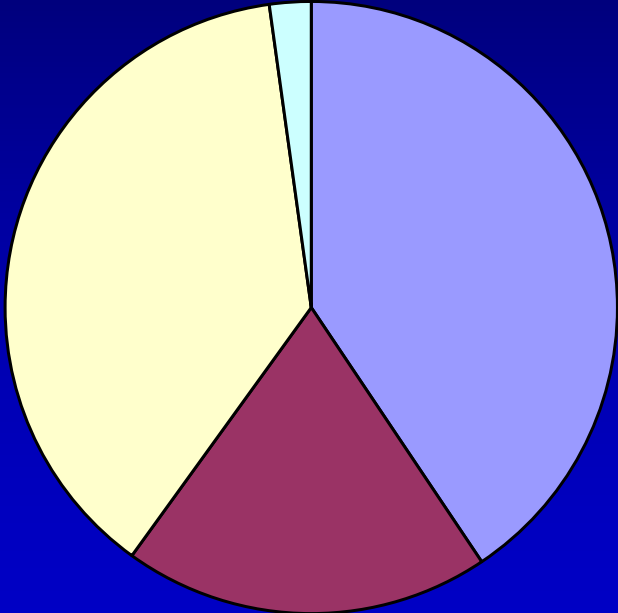


Total assets:
JPY 524.6 billion

Time Deposit,
281.4

Securities,
1320.7

Others, 74.7



Time Deposit,
1418.4

Insurance ,
674.9

Total assets:
JPY 3,488.7 billion

Problems related to employer-sponsored retirement plans

- Employer-sponsored retirement benefit plans are totally discretionary.
 - Not all employees are covered with pension plans
- Most employees receive benefits in the form of lump sum rather than annuities due to:
 - The origin of Japanese retirement plans as lump sum severance pay system
 - Favorable taxation for lump sum payments (see the following slides)
 - It is said that few people actually pay tax on lump sum
 - People want to repay housing loans with lump sum
 - Financial instability of sponsoring companies: vested annuity payments could be reduced (sometimes become zero) in the events of business depression
- Even with annuity option, life annuity is not necessarily the norm in plan design. 10-year or 15-year certain annuities are often found. People could outlive annuities.
 - Many employers that switch from EPFs to New DBs have abolished life annuities
- Under DC plans, participants investment behavior is too conservative to accumulate enough retirement provision

Appendix: Tax treatment of pension plans

- Tax treatment of Defined Benefit (DB) for employees and employers
 - Different tax rules apply to New DB & QPP and to EPF

- Tax treatment of New DB and QPP
 - Employer contributions are a tax-deductible business expense. Employer contributions are not treated as taxable income to employees.
 - Employee contributions are subject to tax deduction, but are coordinated with the deduction for life insurance premiums (Max: ¥50,000 per annum).
 - Plan assets are subject to an annual special corporation tax of 1.173% of plan assets (current moratorium until March 31, 2011 on this tax).
 - **Lump sum benefits are favorably taxed as retirement benefits with a service-related deduction, while annuity benefits are subject to a special income deduction (same treatment as for social security).**

- Tax treatment of EPF
 - Employer contributions are a tax-deductible business expense. Employer contributions are not treated as taxable income to employees.
 - Employee contributions can be deducted from employees' taxable income.
 - No special corporation tax applies unlike New DB and QPP.
 - **Lump sum benefits are favorably taxed as retirement benefits with a service-related deduction, while annuity benefits are subject to a special income deduction (same treatment as for social security).**

Appendix: Tax treatment of pension plans

- Tax treatment of Defined Contribution (DC) for employees and employers
 - Contributions up to the limit are a tax-deductible business expense and are not treated as taxable income to employees. (Note that currently no employee contributions are allowed under Corporate-type DC plans)
 - Investment earnings are tax-deferred to employees
 - Plan assets are subject to an annual special corporation tax of 1.173% of plan assets (current moratorium until March 31, 2011 on this tax).
 - **Lump sum benefits are favorably taxed as retirement benefits with a service-related deduction (the contribution period is considered as the service period), while annuity benefits are subject to a special income deduction (same treatment as for QPPs, EPFs, New DBs, and social security).**

Appendix: Tax rules for benefit payments

- Lump sum benefits:
 - Tax = (Lump sum - retirement income deduction) x ½ x tax rate
 - Separately taxed

Years of participation in retirement plans	Amount of deduction per year
First 20 years	JPY 400,000
Beyond 20 years	JPY 700,000

For example, deduction for 25 years is
 $400,000 \times 20 + 700,000 \times 5 = 11,500,000$

(Example)

If you receive JPY 15,000,000 in lump sum from a retirement plan after 25 years of service, retirement income deduction of JPY 11,500,000 (see above) is deducted. The remainder of JPY 3,500,000 is halved to become JPY 1,750,000 and 5% of tax rate (in this case the minimum rate) is applied to reach the tax amount of JPY 87,500.

**Income tax
rate in
Japan**

Taxable income	Income Tax Rate
JPY 1.95 million or less	5%
JPY 1.95 million - JPY 3.3 million	10%
JPY 3.3 million – JPY 6.95 million	20%
JPY 6.95 million – JPY 9 million	23%
JPY 9 million – JPY 18 million	33%
Over JPY 18 million	40%

Appendix: Tax rules for benefit payments

- Annuity benefits:
 - Tax = (Annuity – annuity deduction) x tax rate
 - Aggregate taxation

(Annuity deduction for those who are less than age 65)

Annual annuity amount including social security old age pension	Annuity deduction
JPY 1.3 million or less	JPY 700,000
JPY 1.3 million - JPY 4.1 million	Annuity amount x 25% + JPY 375,000
JPY 4.1 million - JPY 7.7 million	Annuity amount x 15% + JPY 785,000
Over JPY 7.7 million	Annuity amount x 5% + JPY 1,555,000

(Annuity deduction for those who are age 65 or more)

Annual annuity amount including social security old age pension	Annuity deduction
JPY 3.3 million or less	JPY 1,200,000
JPY 3.3 million - JPY 4.1 million	Annuity amount x 25% + JPY 375,000
JPY 4.1 million – JPY 7.7 million	Annuity amount x 15% + JPY 785,000
Over JPY 7.7 million	Annuity amount x 5% + JPY 1,555,000

Tier 4: Individual Products



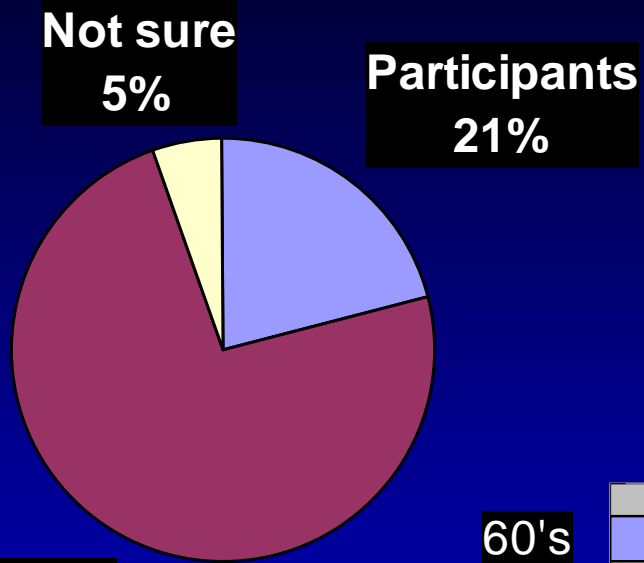
Individual Products

- Capital accumulation products
 - Fixed Annuity
 - Zaikei Nenkin (Asset-building pension scheme)
 - Contributory Pension Plan
 - National Pension Fund
 - Individual-type Defined Contribution (DC) Plan

- Capital-annuitizing products
 - Variable Annuity

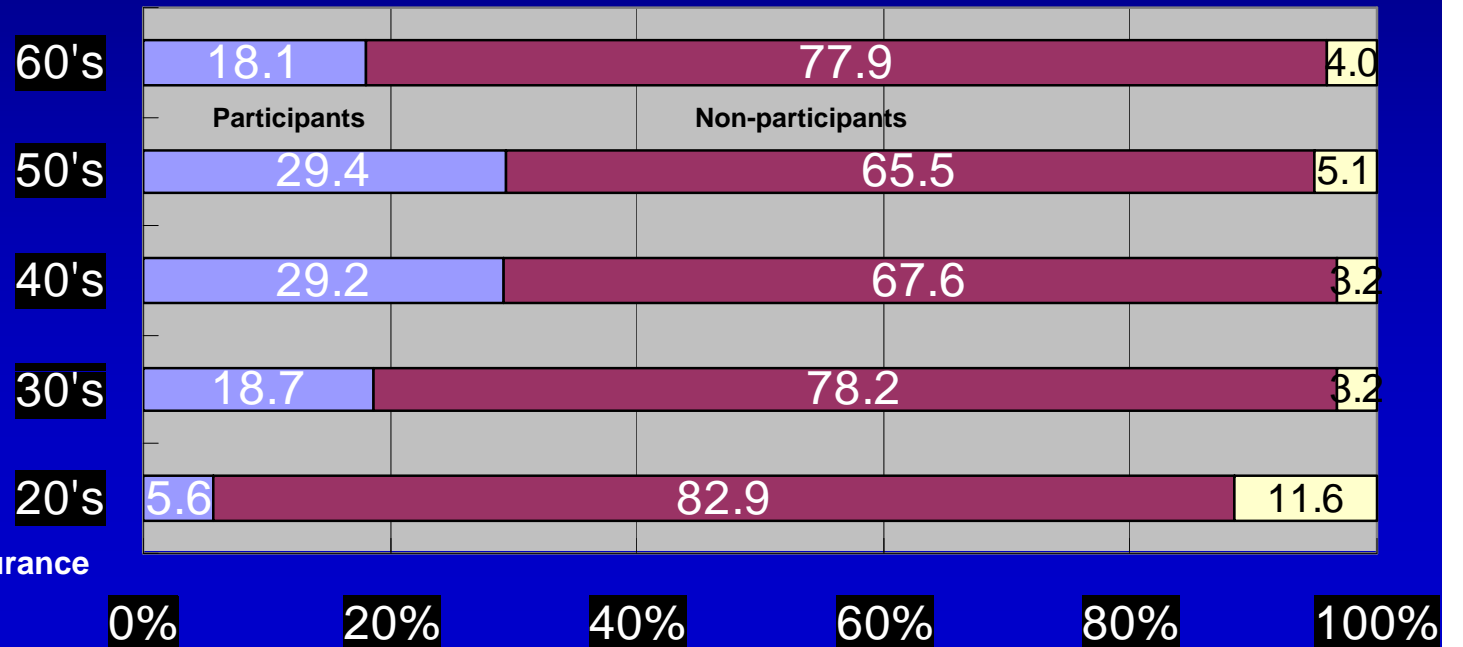
- Reverse mortgage: exists, but not popular

Individual annuities are not prevalent



Non-participants
74%

Ratio of Participation in Individual Annuities by Age



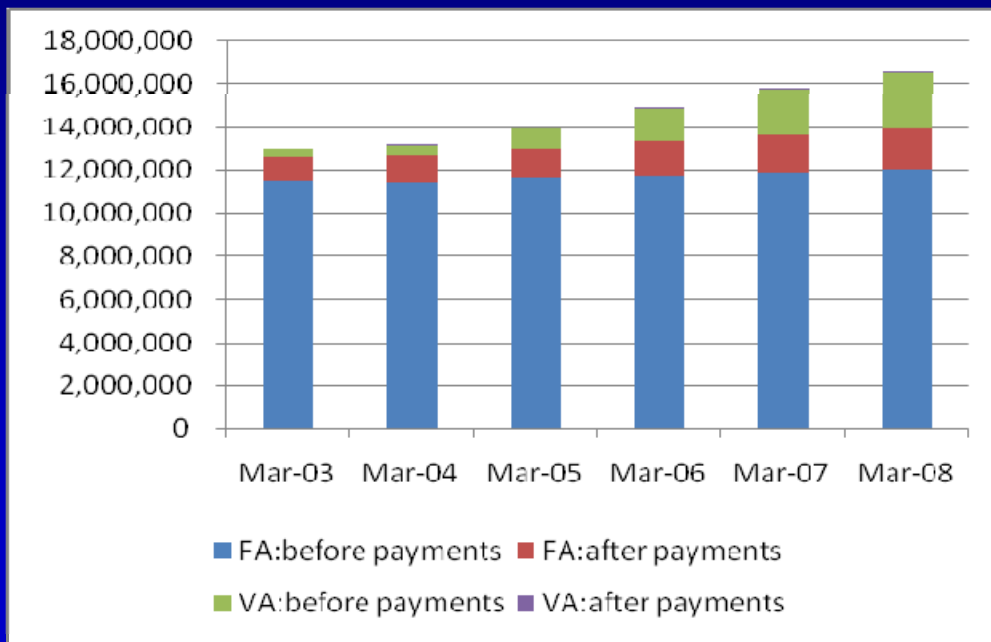
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Data Source: Japan Institute for Life Insurance

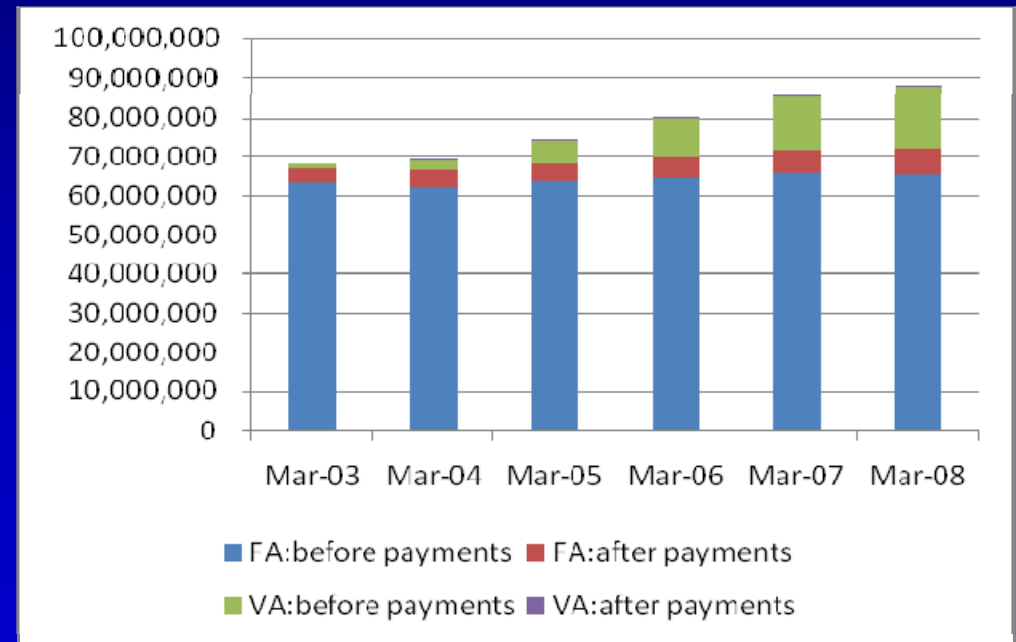
Individual annuity market

- Fixed annuities are stable in terms of the number of policies and of assets for the last six years while variable annuities have grown steadily since its introduction in 1999 in Japan.

The Number of Policies



Assets (Million Yen)



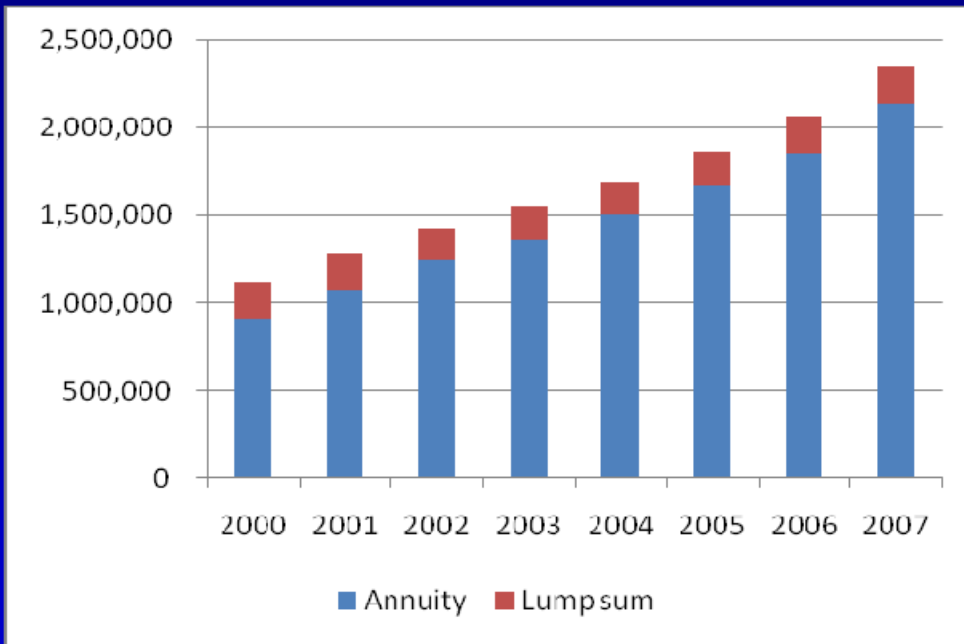
FA: Fixed Annuities, VA: Variable Annuities

Data source: Life Insurance Association of Japan

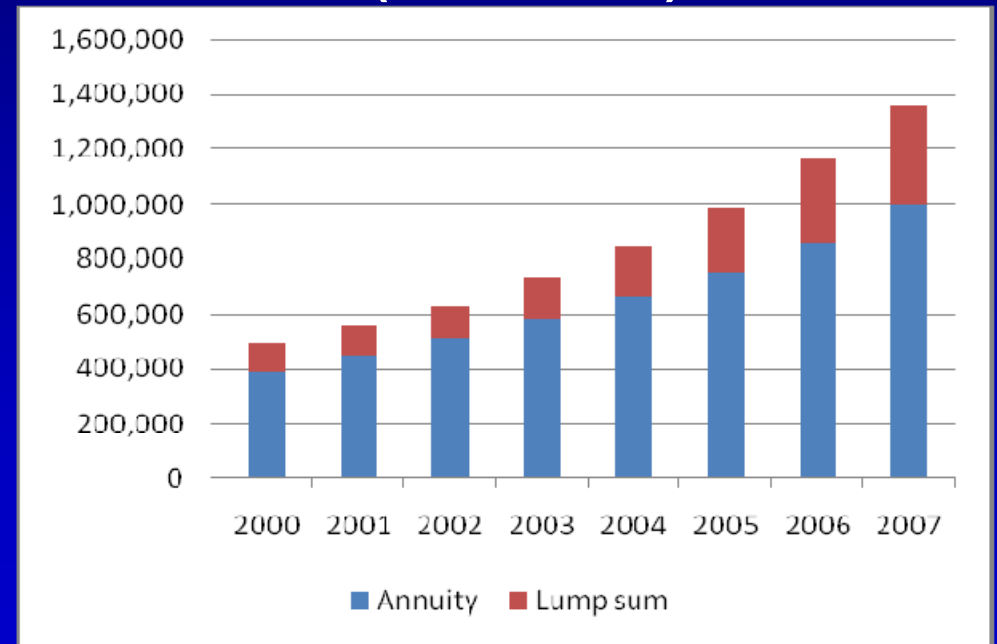
Form of payments in individual annuities

- Most policyholders have received payments in the form of annuities.
- Certain annuities (5-year, 10-year, and 15-year) and life annuities with 10-year guaranteed period are common.

The Number of Cases Paid



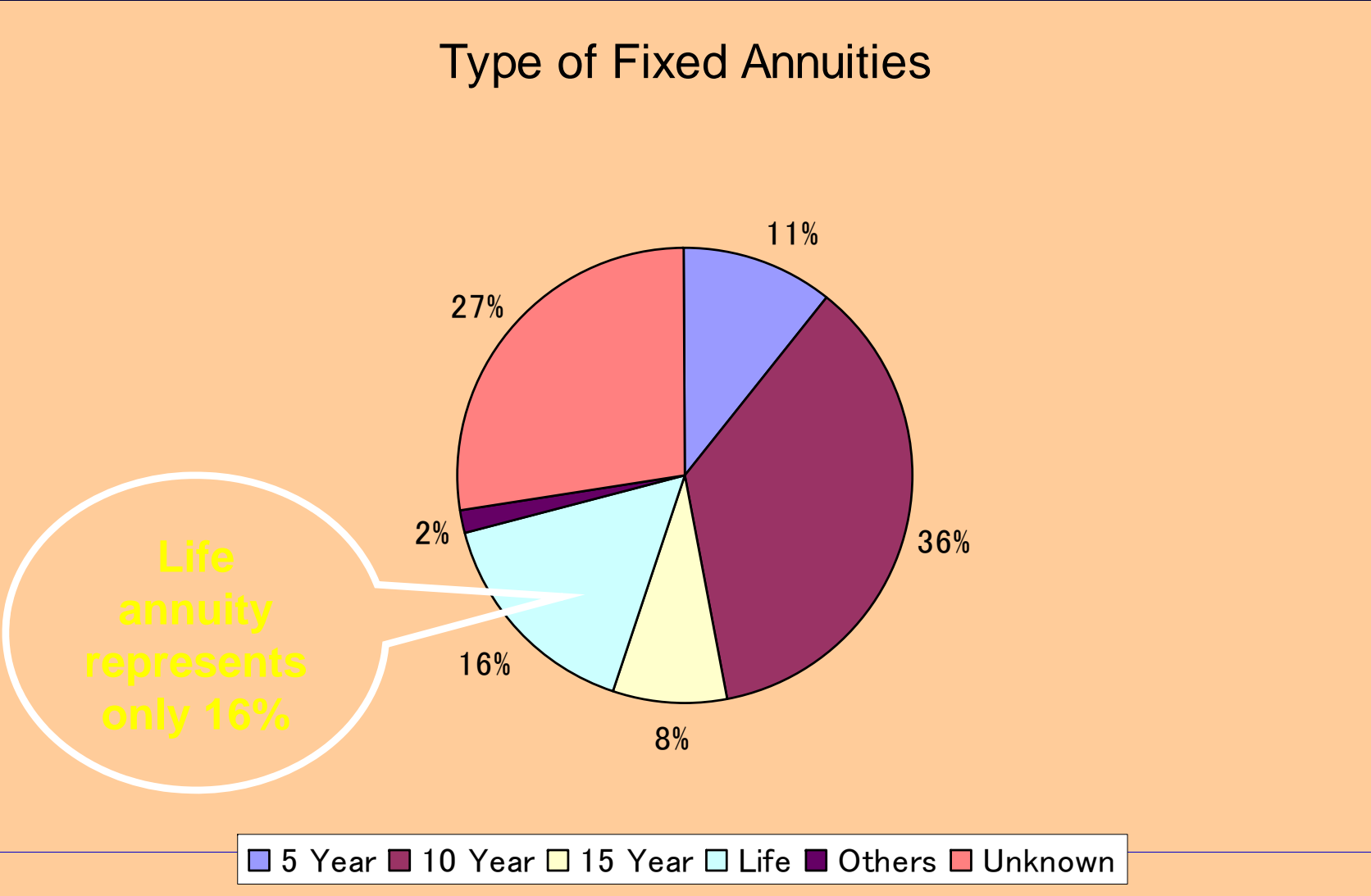
The Amount of Payments (Million Yen)



Data source: Life Insurance Association of Japan

Prevalence of fixed annuities by term

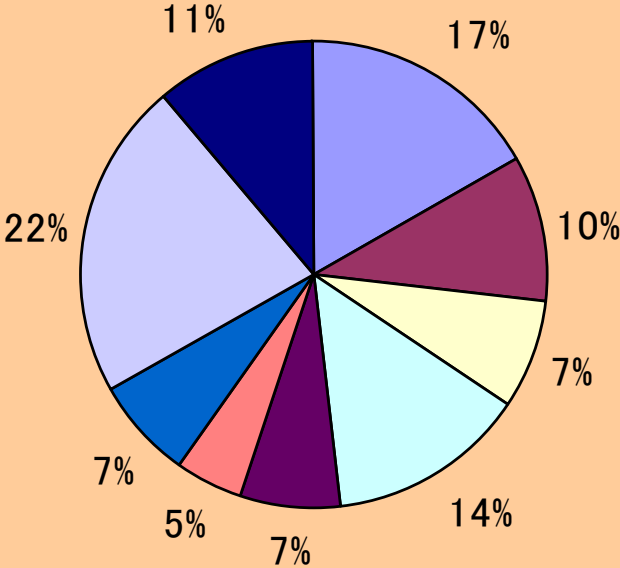
Type of Fixed Annuities



N=741 Data Source: Japan Institute for Life Insurance

Annual amount of fixed annuities

Amount of Annual Annuities (Fixed Annuities)



- Less than JPY 360,000
- JPY 360,000-480,000
- JPY 480,000-600,000
- JPY 600,000-720,000
- JPY 720,000-840,000
- JPY 840,000-960,000
- JPY 960,000-1,080,000
- JPY 1,080,000 or more
- Unknown

N=833 Data Source: Japan Institute for Life Insurance

Variable annuity products in Japan

- Single premium products dominate Japanese VA market
 - VA is an investment vehicle for retirees who received lump sum money upon retirement in Japan
 - Low assumed interest rate of fixed annuity (around 1.0-1.5%) and increase in retirement of baby-boomers contribute to the growth of VA market
- Investment risks are borne by policyholders
 - Some VAs allow policyholders to select investment among several separate accounts
 - Many VAs fix annuity amounts after the commencement of annuity in Japan
- Minimum guarantee features are popular in Japan
 - Almost all VAs guarantee minimum death benefits equal to premiums paid before the commencement of annuity payments.
 - Many VAs guarantee minimum lump sum values, minimum annuity incomes, and/or minimum total annuity values
 - Some VAs guarantee minimum withdrawal amounts in case of cancellation

Variable annuity products in Japan

■ Tax benefits

- Premiums are subject to the deduction for life insurance premiums (Max: ¥50,000)
- Investment earnings are tax-deferred

■ Expenses

- Initial costs: 3-5% of premiums (some VAs have no initial costs)
- Ongoing costs: 3-4% of account balances (1-2% of insurance costs + 0.5-2% of investment management costs)
- Annuity maintenance costs: 1% of annuity amounts
- Surrender charge could apply in case of cancellation

Variable annuity products in Japan

■ Recent innovation

■ Extended guarantee

- 105-120% of premiums paid or accumulated account balances are guaranteed as lump sum values after certain investment periods

■ Ratchet feature

- Guaranteed minimum death benefits and guaranteed minimum lump sum values step up if accumulated account balances exceed certain thresholds (and never decreased again)

■ Target “knocks-out”

- If the value of investment reaches a pre-defined target level (110-150% of premiums paid, selected by policyholders) after certain years, investment vehicle moves to general account and annuity value is fixed. Otherwise, minimum total annuity values are guaranteed.

Zaikei Nenkin

- Zaikei Nenkin (Asset-building pension scheme)
 - Started October 1982
 - Employees contribute on a post-tax basis
 - Interests or investment earnings on asset balances up to JPY 5.5 million (in case of insurance policy JPY 3.85 million) is tax free
 - Considering the low interest rate environment in Japan, this tax benefit is very small
 - No investment direction is possible
 - Annuity payments start at age 60
 - Terms of annuities: five years to 20 years
 - No portability
 - The number of participants is 2,248,000 and the asset size is JPY 3,993 billion

Contributory Pension Plan

- Contributory Pension Plan
 - Sold by life insurance companies to employers
 - Employees contribute to the plan on a post-tax basis
 - Employee contributions are subject to the deduction for life insurance premium of JPY 50,000 per annum
 - All assets are invested in life insurer's general account (the current guaranteed rate is 1.25%)
 - 10,720 employers have provided Contributory Pension Plan to employees and the assets amount to JPY 13,576 billion as of October 31, 2008.

National Pension Fund

■ National Pension Fund

- Started April 1991
- Only self-employed and their spouses can participate.
- Participants can make contributions up to JPY 68,000 per month
 - Contributions are tax-deductible
- National Pension Fund Association (a government body) make assets management
- Benefits are taxed when paid, but some deductions are applicable
- Life annuities (and certain annuities) are paid from age 65
- The number of participants is 648,415 and the asset size is JPY 2,659 billion as of March 2007.

Individual-type Defined Contribution (DC) Plan

- Individual-type Defined Contribution (DC) Plan
 - Started January 2002
 - Only self-employed and their spouses as well as employees whose employers do not sponsor any funded DB plans or Corporate-type DC plan can participate.
 - Contribution limits (tax-deductible)
 - Self-employed and spouses: JPY 68,000 per month or JPY 816,000 per annum (but combined with contributions for National Pension Fund)
 - Employees: JPY 18,000 per month (JPY 216,000 per annum)
 - Participants make investment directions and investment earnings grow tax free.
 - Benefits are taxed when paid, but some deductions are applied
 - The number of participants is only 93,036 as of March 2008

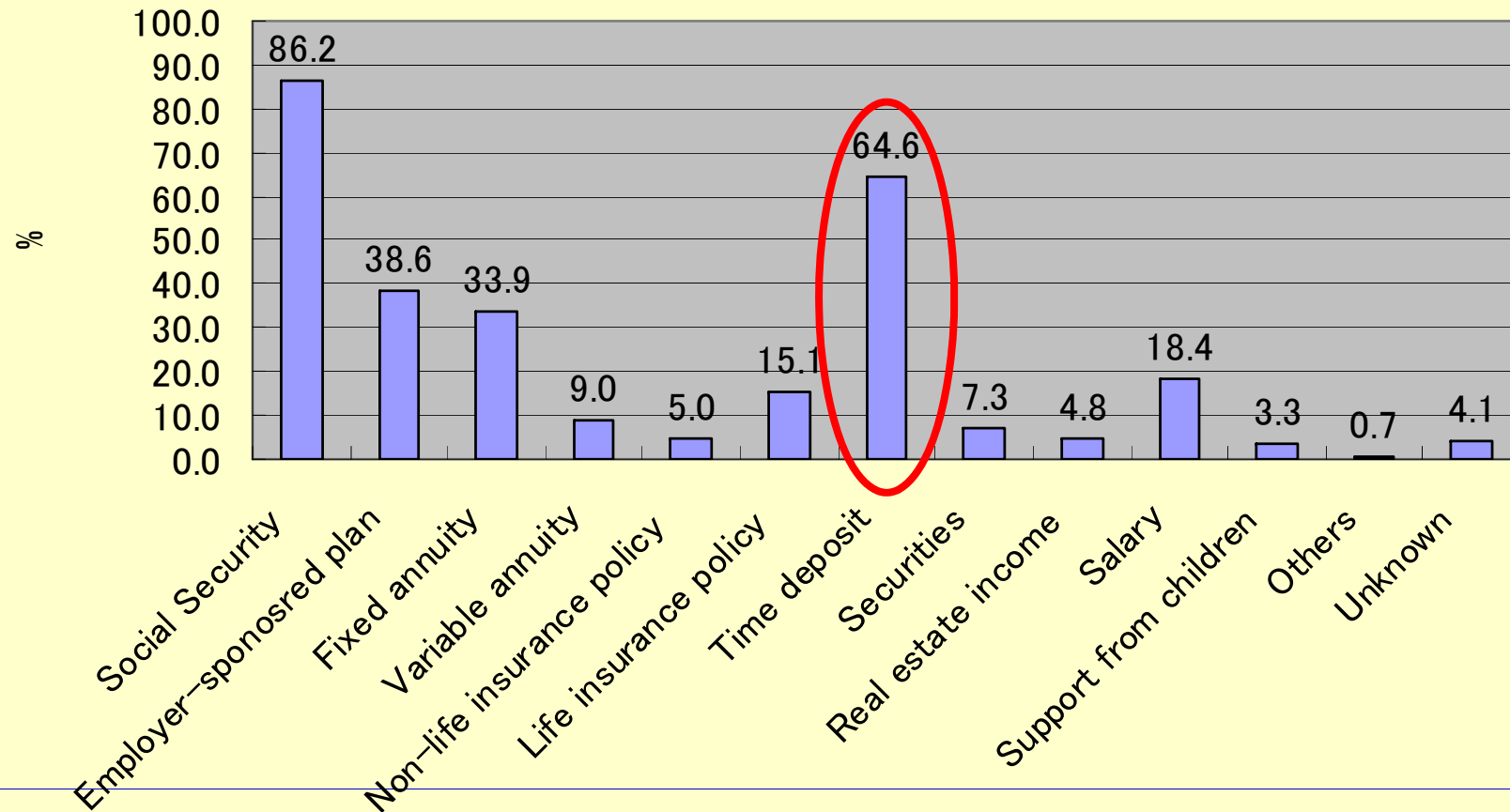
Problems related to individual products

- Despite of the importance of self-supporting efforts for retirement provision, individual products are not popular as capital accumulation vehicle in Japan;
 - Fixed annuity
 - Little tax incentive (Max JPY 50,000 tax deduction annually)
 - Low assumed interest rates (1.0-1.5%)
 - Other products are complex and not well-recognized
 - National Pension Fund and Individual-type DC plans are most tax- advantageous, but limited eligibility and low contribution limits prevents them from growing.
- Not all fixed annuity products and variable annuity products provide life annuities. People could outlive annuities.
- The above may be the results from too much reliance on bank deposits
 - The longevity risks are covered by bank deposits in Japan
 - But is it really efficient ?

Recap: Retirement income resources for Japanese

Means for Retirement Income

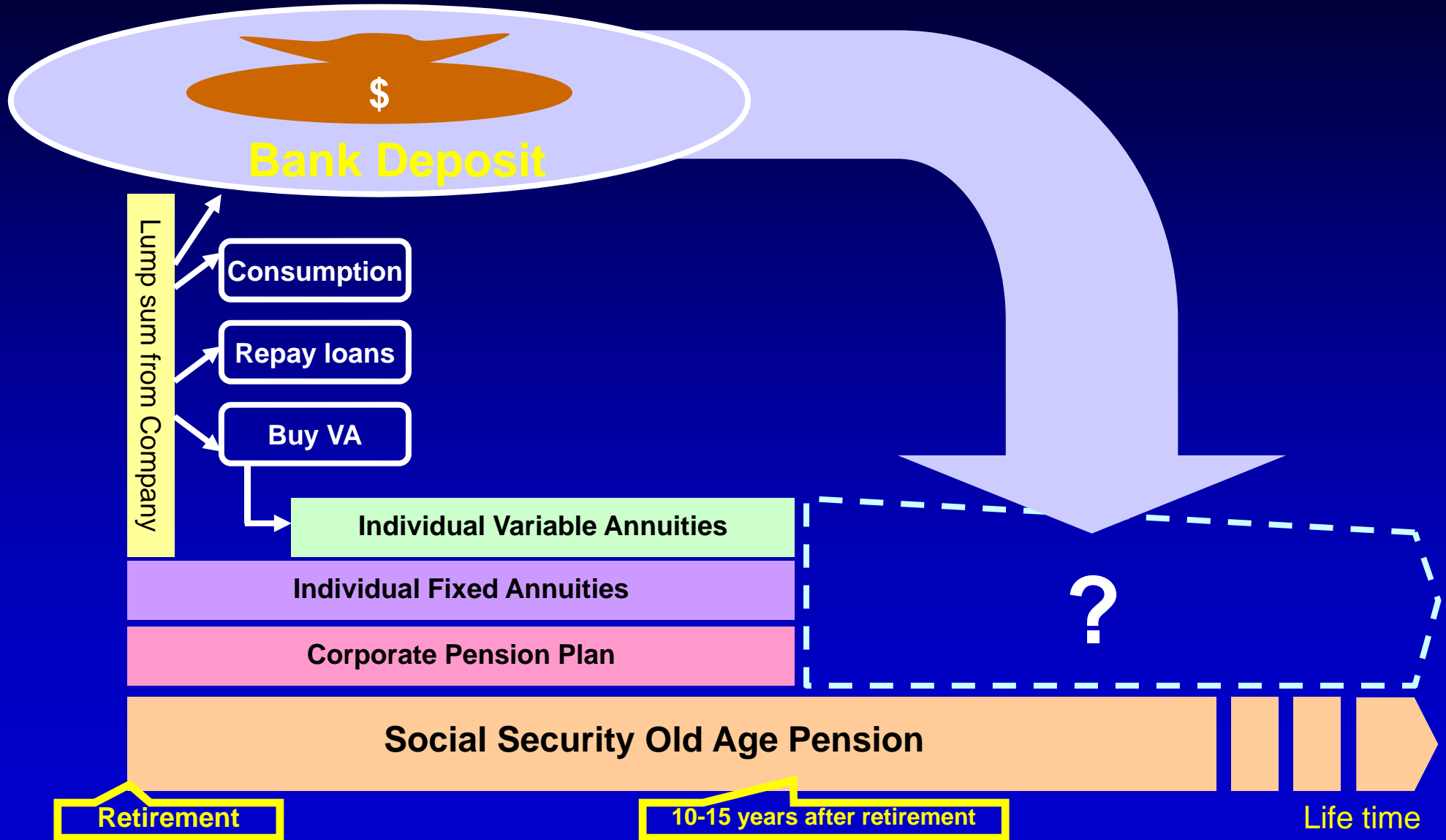
(Percentage of people answered "yes")



N=4059

Data Source: Japan Institute for Life Insurance

The longevity risks are covered by bank deposits in Japan



Problems to be solved

- People just accumulate bank deposits for fear of longevity
 - They do not know how much is necessary for retirement
 - People just prefer bequeathing a fortune to outliving a fortune
 - They do not understand that bank deposits are not necessarily the most economically-efficient products
 - Zero interest rates, no tax incentives

- Financial education as well as financial planners who provide financial education are needed
 - Otherwise, annuity market will not grow in Japan