ICI POLICY PAPER

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Recommendations to Enhance Japan's Defined Contribution Pension System and the Nippon Individual Savings Account Program

FEBRUARY 2024

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Recommendations to Enhance Japan's Defined Contribution Pension System and the Nippon Individual Savings Account Program

ICI and ICI Global[1] applaud Japan's leadership in developing policy reforms to strengthen the asset management industry and encourage greater household participation in the capital markets, including through its "Doubling Asset-Based Income Plan" and the "Policy Plan for Promoting Japan as a Leading Asset Management Center."[2] These reforms should help households adapt to changing macroeconomic conditions by making greater use of the diversified investments offered by asset managers to build household wealth, prepare for retirement, and meet other important financial objectives.

In furtherance of these policy goals, we encourage Japan to enhance its defined contribution (DC) pension system and to continue building on the recent and welcome enhancements to the Nippon Individual Savings Account (NISA) program. Facilitating a shift from savings to investment will be especially critical as the Japanese economy experiences a return of inflation, as an overreliance on holding savings in cash and deposits creates risks that household wealth will erode in real terms over time.

The experience in the United States and other jurisdictions illustrates that reforms by Japan to expand and improve the functioning of its DC pension system, as well as continued enhancements to NISA, would have multiple benefits.

- Given aging demographics, private DC plans—both corporate and individual—can serve as an important complement to the Japanese public pension system, providing households with additional sources of income and resources in retirement.
- Tax-advantaged DC pensions and savings programs can be powerful tools to help foster an investment culture, with increased participation in the programs also leading to increased participation in capital markets.
- Larger pools of investable assets within the DC plan system will also foster additional competition and growth in the asset management industry, which over time can lead to lower DC plan and investment fees and improved services for households, while facilitating the further development of capital markets and financing for the economy.

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[1] ICI Global carries out the international work of the Investment Company Institute, the leading association representing regulated investment funds. With total assets of $41.7 trillion, ICI's membership includes mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and UCITS and similar funds offered to investors in Europe, Asia, and other jurisdictions. ICI's mission is to strengthen the foundation of the asset management industry for the ultimate benefit of the long-term individual investor. ICI Global has offices in Brussels, London, and Washington, DC.

[2] Available at www.fsa.go.jp/en/policy/pjlamc/20231214.html.

In this context, this paper presents ICI's recommendations to foster a more robust DC pension system in Japan, thereby enhancing retirement security, increasing household participation in capital markets, and strengthening the asset management industry.

SUMMARY OF KEY RECOMMENDATIONS

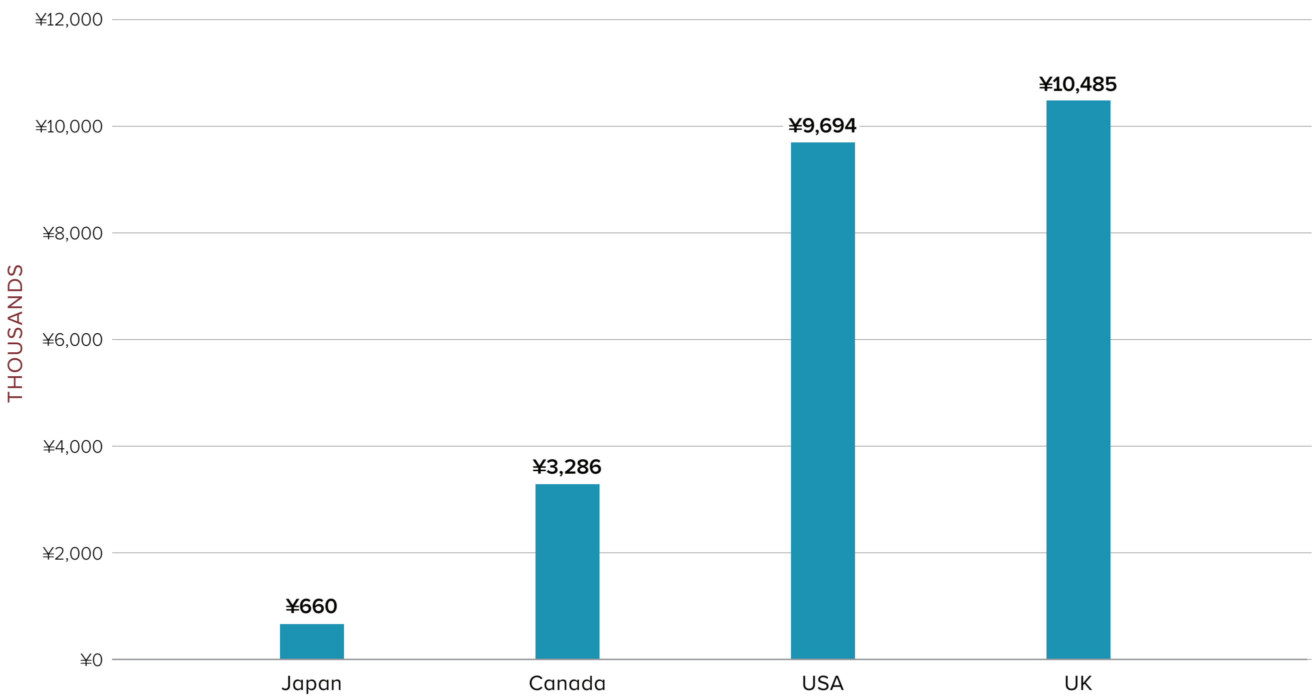
1. Increase the contribution limits for corporate DC plans and for individual-type DC pension plans (iDeCo).
2. Facilitate additional employee contributions to DC plans by removing the restriction that an employee cannot contribute more than the employer, and by allowing older workers to make additional "catch-up" contributions.
3. Encourage greater use of diversified long-term investment vehicles as the default investment for corporate DC plans and iDeCo.
4. Make it easier for plan sponsors to change investment products in DC plans.
5. Further expand the scope of eligible diversified investment products for NISA.
6. Encourage plan sponsors and financial services firms to provide additional interactive online educational resources to individual investors.

RECOMMENDATION 1:

Increase the contribution limits for corporate DC plans and for individual-type DC pension plans (iDeCo).

For a successful DC pension framework, contribution limits (both participant limits and total contribution limits) must be high enough to allow participants to accumulate sufficient investable assets to meaningfully contribute to a household's long-term retirement needs. As illustrated below, contribution limits in Japan are well below those of other jurisdictions with successful and well-developed DC pension systems. We recommend that Japan significantly increase its contribution limits so that DC plans can play a stronger role in supporting long-term retirement security for Japanese households.

Corporate Defined Contribution Pensions Annual Contribution Limits



Source: ICI calculations from national authorities for Japan corporate DC, Canada RRSP, US 401(k), and UK NEST.[3]

As an important complement to the Japanese public pension system, expanding the size of DC pension plan assets over time through increased contribution limits can enhance future retirement security by providing households with additional streams of asset-based income and resources in retirement.

Increasing contribution limits, and thereby permitting larger pools of investable assets within the DC plan system, will not only benefit each participant, it will also foster growth in the asset management industry supporting these DC plans. We anticipate that a larger pool of DC plan assets would facilitate the development of a more vibrant and diverse market for investment services, and over time lower plan and investment fees due to increased competition in the retirement plan market and greater economies of scale.

[3] Contribution limits represent total combined employee and employer contributions. UK contribution limit is inclusive of net increases in defined benefit (DB) pension payments, when applicable. Japan, Canada, and USA are limits for 2024, while UK is as of tax year 2023. Currency conversions are based on average annual 2023 exchange rates from the Federal Reserve Bank of St. Louis, Federal Reserve Economic Data (FRED).

For example, in the United States, the growth in 401(k) plans coincided with the development of lower-cost investment services for the mass market.[4] Through competition and innovation, 401(k) plan participants with modest account balances today can invest in a diversified investment portfolio at a lower cost than could wealthy investors 30 or 40 years ago. Such improvements may make participating in DC plans more attractive for Japanese citizens, and can be especially helpful for younger or lower-income participants by making investing more accessible.

RECOMMENDATION 2:

Facilitate additional employee contributions to DC plans by removing the restriction that an employee cannot contribute more than the employer, and by allowing older workers to make additional "catch-up" contributions.

We recommend that Japan take steps to facilitate additional employee contributions to DC plans. Along with supporting retirement security, employee contributions can help foster a stronger investment culture and encourage households to engage with capital markets, deepening households' balance sheets and bolstering long-term financial well-being.

We suggest two specific policy measures to facilitate additional employee contributions:

» **Eliminate the restriction that an employee cannot contribute more to a corporate DC plan than the employer.** Current restrictions result in differing treatment for employees across firms based on differences in employer contributions and can limit the ability of some plan participants to make full use of the benefits and tax incentives of their DC plans in cases where employer contributions are less than 50 percent of the total contribution limit. Removing this restriction would give participants greater freedom to contribute in a manner that suits their individual needs and stage of life.

» **Allow older workers to make "catch-up" contributions.** A catch-up contribution is an additional contribution that may be made to a DC plan by employees that are beyond a certain age. In the United States, for example, workers that are age 50 or older are eligible to make catch-up contributions. Catch-up contributions recognize that an individual's earnings typically increase over time, and it may be more feasible for an employee later in their career to make larger contributions compared to an employee at the beginning of their career.

[4] See S. Holden, C. Rybak, and E. B. Chism, 2023, "The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2022," *ICI Research Perspective* 29, no. 6 (July); available at www.ici.org/files/2023/per29-06.pdf.

RECOMMENDATION 3:

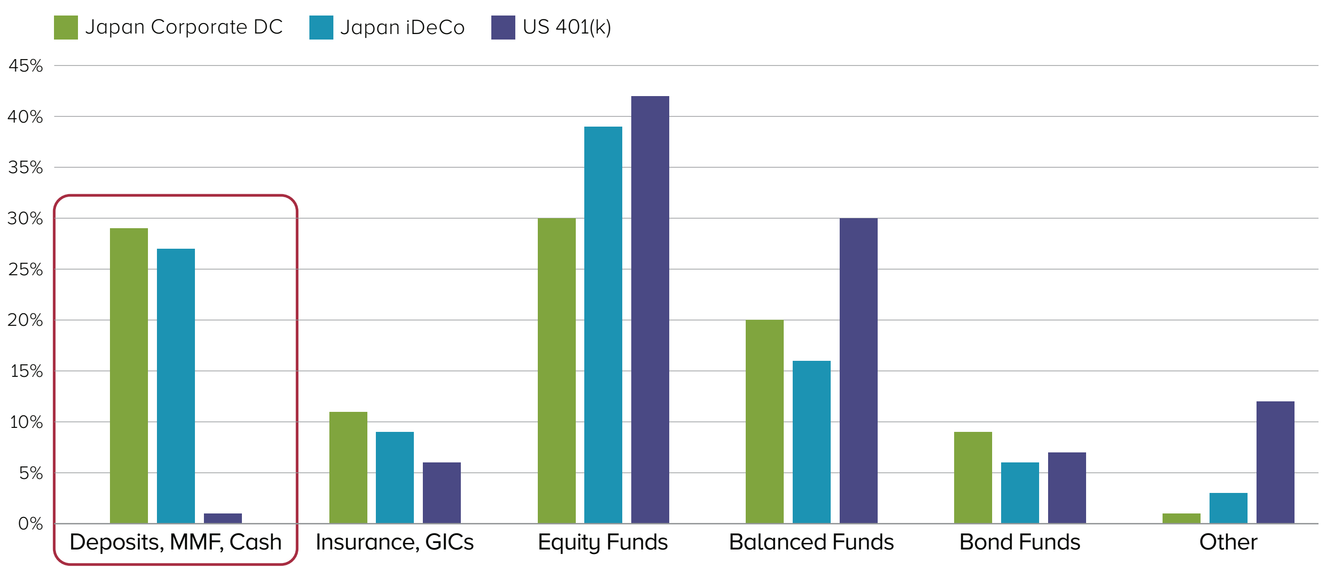
Encourage greater use of diversified long-term investment vehicles as the default investment for corporate DC plans and iDeCo.

To help foster a shift from saving to investing for retirement, we recommend that Japan generally encourage investment in diversified, long-term products as the default investment for DC plans, rather than an overreliance on cash or capital preservation products. Using diversified investments as the default investment, especially for workers who are relatively early in their careers, can foster greater deployment of retirement savings into productive and growth-oriented investments that have the potential to increase asset-based income and better meet individuals' long-term retirement needs.

Currently, nearly 30 percent of the assets held in corporate DC and iDeCo plans in Japan are held in cash deposits (¥ 6.6 trillion) and another approximately 10 percent are in insurance products (¥ 2.5 trillion).[5] By contrast, only 8 percent of US 401(k) assets are held in products designed to preserve principal and maintain liquidity, such as money market funds and guaranteed investment contracts (GICs). Meanwhile, nearly 80 percent of assets in US 401(k) plans are invested in mutual funds and collective investment trusts focused on equities, bonds, and balanced strategies.[6]

Japanese DC Plans Hold a Much Larger Portion in Cash and Deposits than US 401(k) Plans

Percentage of total assets



MMF = money market funds. GICs = guaranteed investment contracts.

"Other" includes commodities, real estate, and individual stocks and bonds.

Sources: ICI calculations from Pension Fund Association and BrightScope and Investment Company Institute, *The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans, 2020*

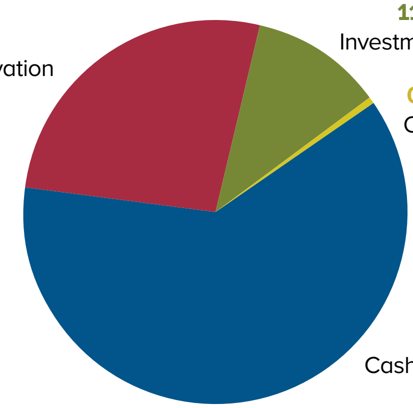
5 See Pension Fund Association, 2023, *Defined Contribution Pension Status Survey Results (2021 financial results)* ; available at www.pfa.or.jp/activity/tokei/files/dc_chosa_kessan2021_1.pdf.

6 See BrightScope and Investment Company Institute, 2023, *The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans, 2020*, San Diego, CA: BrightScope and Washington, DC: Investment Company Institute; available at www.ici.org/files/2023/23-ppr-dcplan-profile-401k.pdf.

Exacerbating this situation, the majority of Japanese corporate DC plans have not designated a default investment vehicle, resulting in contributions flowing into deposits or other cash equivalents. Those corporate DC plans that do select a default investment option overwhelmingly select capital preservation products. As a result, over 88 percent of corporate DC plans in Japan currently place contributions by default into cash and cash equivalents (61.8 percent) or capital preservation products (26.6 percent) such as insurance products.[7] While cash savings and capital preservation may have had more limited downsides when Japan was experiencing deflation, Japan's changing macroeconomic conditions and the return of inflation underscore the need to shift towards diversified investments that can provide long-term growth.

Japan Corporate DC Plan Default Investments

Percentage of corporate DC plans



Source: ICI calculations from Pension Fund Association 2021 data www.pfa.or.jp/activity/tokei/files/dc_chosa_kessan2021_1.pdf

Changes to government laws and regulations can play a critical role in encouraging a shift towards diversified investments, and we suggest Japan take further policy measures toward this goal. Such measures could include updated regulatory guidance to encourage plan sponsors to make greater use of diversified long-term investment vehicles as the default, and potential protections for DC plan sponsors when selecting such diversified approaches.

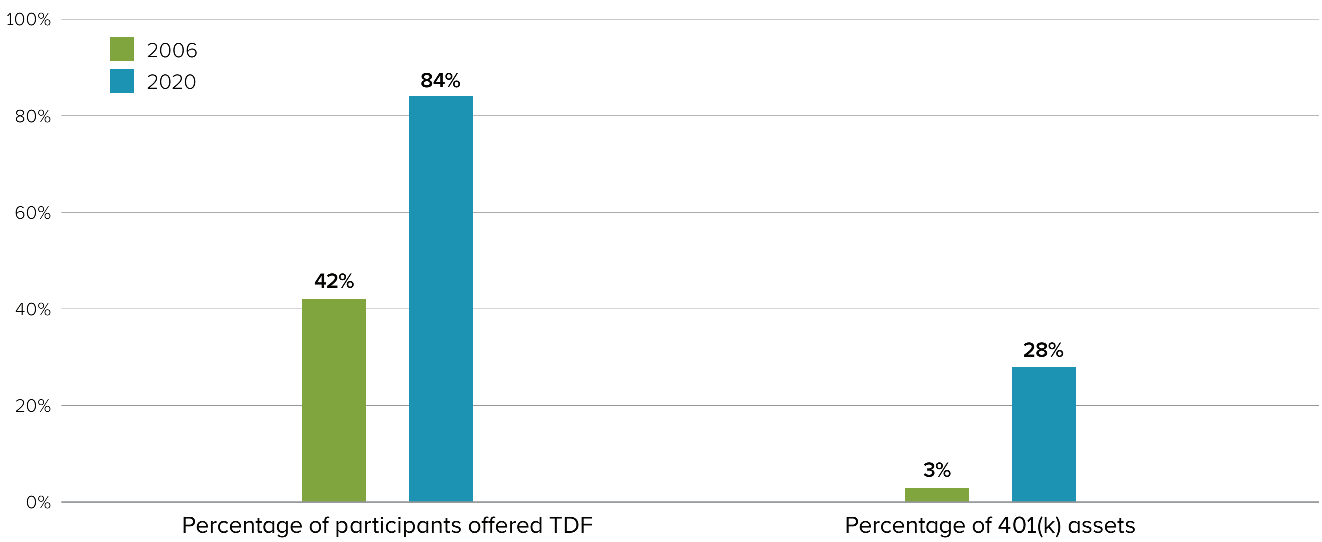
[7] See note 5.

For example, in the United States, prior to the adoption of the Pension Protection Act of 2006 (PPA), DC plan sponsors were concerned about potential legal liability if a default investment experienced losses. As a result, many plan sponsors selected capital preservation products as their plans' default investment, which by definition also limited the potential returns. The PPA encouraged diversification of 401(k) plan investments by establishing a "safe harbor" protection for DC plan fiduciaries from litigation challenging a decision to select certain types of default plan investments, now known as "qualified default investment alternatives" (QDIAs).

Critically, US Department of Labor (DOL) regulations implementing this PPA requirement provided safe harbor protection for a decision to utilize balanced funds, target date funds, and diversified managed accounts as QDIAs, but did not extend this protection to capital preservation alternatives outside of their temporary use. In making this determination, the US DOL took the view that to be accorded QDIA protections, default investments should be long-term investments and that such investments are more likely than capital preservation products to produce rates of return over time that help provide adequate retirement savings.[8]

The effects of these policy changes can be seen in the increased use of target date funds[9] by US 401(k) plans. Since the 2006 PPA, 401(k) plans have become more likely to offer target date funds (and to designate them as the default plan investment option), with the share of total plan assets invested in these funds rising from 3 percent in 2006 to 28 percent in 2020.

The Use of Target Date Funds in US 401(k) Plans Has Increased Since the 2006 PPA



Source: BrightScope and Investment Company Institute, *The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans, 2020*

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[8] See *Default Investment Alternatives Under Participant Directed Individual Account Plans*, 72 Fed. Reg. 60452, 60463 (US Department of Labor, Oct. 24, 2007); available at www.govinfo.gov/content/pkg/FR-2007-10-24/pdf/07-5147.pdf.

[9] A target date (also known as lifecycle) fund typically rebalances its portfolio to become less focused on growth and more focused on income as it approaches and passes the target date of the fund, which is usually included in the fund's name.

There also has been interest in the use of default investment strategies and of target date funds across many jurisdictions in Asia. For example, Hong Kong's Mandatory Provident Fund has established the Default Investment Strategy (DIS) as a globally diversified investment strategy for members that have not specified a fund choice.[10] Meanwhile, jurisdictions such as Korea have seen steady growth in the use of target date funds in recent years.[11]

Making the shift to greater use of diversified investment vehicles as the default will need to include education and engagement between plan sponsors and workers, including clear disclosure. As long as DC plan participants are clearly informed by the plan sponsor about the default investments and about their ability to select a different investment option if they choose, plan participants will remain empowered to make decisions that suit their individual situation and risk tolerance.

RECOMMENDATION 4:
Make it easier for plan sponsors to change investment products in DC plans.

DC plans typically allow participants to choose from a variety of investment options that offer participants diversification and that cover a range of investment risk and return options. In order to provide appropriate investment options for participants on an ongoing basis and to allow for competition among investment product providers, plan sponsors should have the flexibility to change product offerings when needed.

However, we understand that some plan sponsors in Japan reportedly hesitate to replace existing products with newer and more suitable products due to the administrative challenges involved with removing and replacing existing DC plan products. This situation constrains timely product replacement and reduces the ability for product offerings to evolve together with changing investor needs and preferences. Building on previous reforms related to this issue, Japan could further simplify the process to allow plan sponsors and plan administrators to more easily replace and substitute new products when needed. Japan could also consider allowing "mapping" of the investments in which investments and contributions could be transferred into a comparable replacement fund, subject to appropriate disclosure and notification.

[10] See Mandatory Provident Fund Schemes Authority, *MPF Investment, Investment Portfolios: Default Investment Strategy*; available at www.mpfa.org.hk/en/mpf-investment/portfolio/default-investment-strategy.

[11] See Cerulli Associates, 2023, *Target-Date Funds in Asia Gain Renewed Interest* (October 28; Singapore); available at www.cerulli.com/press-releases/target-date-funds-in-asia-gain-renewed-interest.

RECOMMENDATION 5:

Further expand the scope of eligible diversified investment products for NISA.

ICI welcomes and strongly supports the Japanese government's recent expansion of and enhancements to the NISA program.[12] We anticipate that these enhancements will provide a significant boost to NISA's usage and effectiveness, helping to encourage individuals in Japan to move beyond deposit-based savings and shift into long-term investments.

Tax-advantaged savings programs such as NISA are more likely to be effective in helping individuals invest when the programs offer participants a broad selection of investments that provide a wide range of asset classes, strategies, and investment risk and return options. This approach allows participants to tailor their investments to meet their individual needs and financial circumstances.

To further improve NISA's value for individual investors and help incentivize its wider use, we recommend that Japan expand the investments that would qualify under NISA to include a broader range of asset classes and investment strategies. Specific recommendations include:

» **Relax the current restrictions on the use of derivatives.** We support the policy intent of limiting the use of highly leveraged strategies within NISA-eligible products. However, certain strategies, such as in active fixed-income funds and multi-asset funds, routinely use derivatives to mitigate interest rate and other risks, thereby improving investment returns. The current rules, based on a very narrow interpretation of "hedging purposes," overly limit the responsible use of derivatives and unnecessarily exclude from NISA eligibility many well-established, highly regulated funds that use derivatives. To better meet the policy intent without unnecessarily excluding such funds, the authorities could consider better defining the intended limit on the level of leverage. By doing so, the authorities can facilitate a more accurate interpretation of derivatives use and allow for more funds that are effectively managing leverage to qualify under the program and be included in the list of NISA-eligible funds.

[12] NISA provides tax exemptions for individuals on capital gains, dividends, and interest earned on investments made in the NISA account, subject to certain restrictions. See Financial Service Agency, *New NISA*; available at www.fsa.go.jp/policy/nisa2/about/nisa2024/index.html. See also, "Revamped NISA program launched to spur investment wave in Japan," *The Japan Times* (January 1, 2024); available at www.japantimes.co.jp/business/2024/01/01/markets/nisa-revamped-investment-japan.

- **Relax the restrictions on the types of investments eligible under NISA, particularly for Tsumitate (installment) NISA.**[13] Permitting NISA participants, including in Tsumitate NISA, to invest in a wider range of investments would help empower them to build investment portfolios that meet their specific long-term financial needs and preferences. Suggested changes include:
    - Allow greater use of investment in fixed-income index funds. Fixed-income index funds are a natural complement to the equity and multi-asset products currently allowed under the program.
    - Adjust or eliminate the minimum investment unit amount for exchange-traded funds (ETFs). To qualify under Tsumitate NISA, the minimum investment unit for ETFs currently cannot exceed ¥1,000. This requirement risks limiting Tsumitate NISA participants from having access to invest in the full range of ETFs since the unit price of ETFs in Japan often may exceed this amount.
    - Reduce the AUM-related eligibility requirements for foreign-traded investment funds and ETFs to align with those for domestic funds under Tsumitate NISA. Currently, foreign-traded ETFs are required to satisfy a higher minimum AUM amount than domestic funds to qualify under Tsumitate NISA, which limits the range of qualifying funds available to participants.
    - Ease the limitations on eligibility of investment funds that make distributions within a period of one month or less so that participants are able to select the mix of distributions and reinvestments that meet their individual circumstances.

RECOMMENDATION 6:

Encourage plan sponsors and financial services firms to provide additional interactive online educational resources to individual investors.

We welcome the Japanese government's initiative to establish a new organization in 2024 focused on financial education and advice and to expand the availability of financial education and advice for users of NISA, iDeCo, and other retirement programs. Japan's current requirement that corporate DC plans provide ongoing investor education also is valuable. Educational materials and resources can improve the ability of individuals to effectively evaluate their long-term investment and retirement needs and make better-informed choices.

The importance of investor education is illustrated by a recent study, which found that people in Japan with higher financial literacy are likely to make more stock investments and can obtain higher yields from these investments. This study also found that those with higher financial literacy were more likely to take financially desirable actions such as pursuing diversified investment portfolios and life planning.[14]

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[13] Tsumitate NISA is a type of NISA account in which participants commit to a specific monthly contribution. See Financial Services Agency, *Tsumitate NISA*; available at www.fsa.go.jp/policy/nisa2/about/tsumitate/index.html.

[14] See N. Yamori and H. Ueyama, 2020, "Financial Literacy and Securities Investments," Research Institute for Economics and Business Administration Discussion Paper Series, Kobe University; available at www.rieb.kobe-u.ac.jp/academic/ra/dp/English/DP2020-08.pdf.

To further enhance the effectiveness of investor education efforts, we suggest that Japan encourage DC plan sponsors and financial services firms to make use of available technologies to provide personalized interactive online educational tools, such as online investment calculators, as a part of their services. Individualized, interactive online educational resources, such as online calculators that can be used to estimate future financial needs and the effects of different contribution choices, can greatly enhance plan participants' engagement with their retirement savings and investment plans. Increasing DC plan participants' level of engagement also can lead to greater levels of savings and investment.

For example, survey data in the United States indicated that individual savings rates increased when DC plan participants were provided with individualized information such as calculations on available monthly income during retirement, projected health care costs in retirement, and the retirement savings behavior of their peers.[15] A separate study using data from the Netherlands found that increased interactivity in online pension planners had a positive effect on participants' intention to check their personal pension situation in the upcoming three to six months.[16] Survey data in the United States also found that 93 percent of 401(k) participants valued the online financial and retirement tools available on their 401(k) provider's website, and that engaged plan participants save approximately 50 percent more than their non-engaged peers.[17]

CONCLUSION

With aging demographics and shifting macroeconomic conditions, retirement security in Japan can be enhanced through the increased use of DC plans, as well as a shift from a focus on savings and capital preservation towards long-term investment growth. Reforms by Japan to further develop its framework for DC plans at the individual and corporate level, as well as continued development of other tax-advantaged investment programs such as NISA, can be powerful tools to help households meet their long-term financial needs while also fostering a stronger investment culture.

In support of Japan's policy objectives and the long-term financial well-being of Japanese households, ICI stands ready to serve as a resource for Japan in further developing and implementing the policy recommendations presented in this paper, as well as other priority reforms Japan may consider to meet its financial policy goals.

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[15] See "Empower Draws Participant Engagement With Estimated Retirement Income," *PlanSponsor* (January 31, 2018); available at www.plansponsor.com/empower-draws-participant-engagement-estimated-retirement-income.

[16] See E.C. Brüggen, T. Post, and K. Schmitz, 2019, "Interactivity in online pension planners enhances engagement with retirement planning – but not for everyone," *Journal of Services Marketing*, Vol. 33 No. 4, pp. 488–501; available at https://doi.org/10.1108/JSM-02-2018-0082.

[17] See Empower, 2023, *Empowering America's Financial Journey*; available at https://docs.empower.com/empower-institute/2023-Corporate-EAFJ-Study.pdf.

APPENDIX: Additional References and Lessons Learned from Defined Contribution Pension and Retirement Policies in the United States

The US retirement system has evolved over time. The Employee Retirement Income Security Act of 1974 (ERISA) created individual retirement accounts (IRAs) and put in place protections around workplace defined benefit (DB) and defined contribution (DC) plans.

Between 1982 and 2001, policymakers changed the contribution limit rules, substantially reducing the contribution limits to DC plans (including 401(k) plans). The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) partially reversed this by increasing retirement plan contribution limits and introducing “catch-up contributions” for workers age 50 or older.

Five years later, the Pension Protection Act of 2006 (PPA) introduced significant changes designed to make retirement saving at work easier and more rewarding, including further encouraging automatic enrollment for DC plans, such as 401(k) plans, while paving the way for diversified default investments. These changes made a difference: 401(k) plans held US$6.6 trillion in assets at year-end 2022, in more than 710,000 plans, on behalf of about 70 million active participants and millions of former employees and retirees.

Recognizing that retirement savers should not put all of their eggs in one basket, the PPA also facilitated diversification of 401(k) investments by generally requiring DC plans to permit participants to diversify out of employer stock, and by protecting DC plan sponsors from litigation when selecting default investment options that invest in a mix of asset classes focused on growth and income rather than using short-term capital preservation vehicles such as money market funds as default investments. Specifically, the US Department of Labor (DOL) issued guidance that balanced funds, target date funds, and diversified managed accounts could be used as qualified default investment alternatives (QDIAs) that would enjoy a regulatory “safe harbor” from challenge. The DOL did not accord this preferential treatment to capital preservation funds outside of their temporary use.

With the 2022 passage of the SECURE 2.0 Act, the US retirement system continues to develop. Key provisions of this Act included the promotion of automatic enrollment, with automatic enrollment generally becoming mandatory for new plans beginning in 2025, aiming to increase participation in 401(k) and other DC plans. The Act also will support participants starting to save for retirement earlier by allowing employers to offer participants employer matching contributions to their retirement accounts based on their student loan payments. The Act also will help expand pooled employer plans, giving additional opportunities for individuals to access employer-sponsored retirement savings tools and build for a secure financial future.

For additional resources, please see the ICI website library for Key Lessons from the US 401(k) and IRA system, available in English and Japanese including:

- » Contributions Are Key to Retirement Savings Success
  English | Japanese
- » Investment Choice Is Key to Retirement Savings Success
  English | Japanese
- » Tax Treatment Is Key to Retirement Saving Success
  English | Japanese
- » Encouraging Automatic Enrollment Is Key to Retirement Saving Success
  English | Japanese
- » Disclosure Is Key to Retirement Saving Success
  English | Japanese
- » Limited Access Is Key to Retirement Saving Success
  English | Japanese
- » Portability Is Key to Retirement Saving Success
  English

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