Japan Update
DC fiduciary duties to be enhanced

April 3, 2018

Legislative changes for DC schemes will come into effect from May 1, 2018. The revision of the law aims to promote plan sponsor's fiduciary duty and improve the quality of DC plans.

Overview

A set of revisions to the law governing Defined Contribution pension schemes ("DC") will come into effect as of May 1, 2018.

The changes can be summarized in the following key points:

- Consent requirement to eliminate investment products from the portfolio will be eased.
- Number of investment products offered will be capped at 35.
- Review of the service quality of DC vendors will be required at least once every five years.
- The requirements a default investment product must meet will be changed.
- Efforts to provide continuous investment education will be required.

Portfolio management and vendor review

The first 3 items above aim to help plan sponsors in delivering better Defined Contribution offerings to their participants through addressing the pain-points with DC vendors.

In many Japanese DC plans, employee profits are undermined by high investment management fees of investment products. Oftentimes, fund companies providing these products are in the same company group as the plan vendor, creating a conflict of interest, where vendors do not have the interest to exclude overly expensive products from their offerings.

Even with passive funds, there are cases where the highest investment management fee is more than 4 times larger compared to that of the lowest, offered by the same provider.

In addition, to remove an investment product from the portfolio, current regulation requires unanimous and active consent from members investing in it, making changes practically impossible.

The revision will ease this consent requirement to two-third of such participants. Moreover, members not declaring their decision will be deemed to have agreed to the removal. These changes will help the sponsor to maintain a healthier and better investment portfolio by excluding underperforming or expensive products.

Capping the number of investment options will make the portfolio easier to navigate for participants. Further, it'll place more responsibility on the sponsor to carefully review products already in the portfolio and new ones intended for inclusion.

In addition to the above, sponsors will need to review the service quality of DC vendors at least every 5 years, and, if needed, consider changing to another provider.

These revisions are expected to drive a change so that plan sponsors select DC vendors and investment products in a way that will enhance employees' profit and deliver an overall better DC scheme to participants.

Investment behaviour of plan participants

The last 2 points aim to change the way how plan participants' assets are invested.

Majority of DC participants in Japan invest their assets in principal guaranteed products. These products command a lower rate of return, and finally lead to lower income in retirement than the plan sponsor anticipated.

The redefinition of requirements a selected default investment product must meet is a step to solve this issue. Even now, plan sponsors can designate products other than those with principal guarantee as default option, but there are very few examples where this is actually adopted.

With the revision, we expect to see an increasing number of plans sponsors that designate default products more in-line with employees' needs (such as balanced funds and target-date funds).

It is important however, that both sponsor and participants have proper knowledge about these products and understand the possible merits and risks.

To foster this knowledge, investment education requirements will be strengthened and sponsors will need to make efforts to provide continuous investment education to participants. Although specific penalty provisions are not established at this time, authorities may demand companies to report steps they have taken to meet this requirement.

In Japan, financial literacy of DC plan participants is considered to be lower than that of other countries, so strengthening investment education will certainly help them to exploit the possible gains of a DC scheme.

Impact on DC sponsors

So, what will be the impact on employers?

DC sponsors should pay more attention to fiduciary duties, including the review of competitiveness of vendor services and investment products.

As the changes to consent requirements will enable sponsors to eliminate underperforming or expensive investment products, their obligation to exercise this right will also surface. If a sponsor does not fulfil its fiduciary duties and continues to offer suboptimal investment options, it may be ruled to have harmed participants' profits through negligence.

So far, no DC participant in Japan has filed lawsuits about such cases, but there is no doubt that the risk will increase in the future and sponsors will need to pay more attention to avoid litigation.

How can we help?

At Aon, we provide DC vendor and investment portfolio review services. We can offer an objective evaluation since we have no ties with the financial institutions providing the investment products.

We have also partnered with an external financial education institution to offer support services relating to continuous investment education and "financial wellness". On top of traditional DC investment education, they can provide personal finance education, achieving increased employee engagement and productivity as a result.

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