A Tale of Two Pension Reforms: A US-Japan Comparison

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Abstract

This paper tackles the vexing issue of corporate pension reform in the U.S. and Japan. Both countries are undergoing structural and demographic changes in their workforce and corporate governance, giving urgency to the problem of pension funding and solvency. Urgency has led to different responses at the political, corporate, and societal levels. Behind this, we find legacy institutions and norms peculiar to each country that are evolving under different economic realities.

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As Baby Boomers retire in the US and Japan over the next several years, the reality of rapid population aging will begin to set in, which is sure to foster a sense of urgency regarding whether current standards of living can be maintained over the next several decades. In particular, with the graying of human assets and steady declines in the dependency ratio,[1] countries like the US and Japan will tend to ask their retirees to secure more of their retirement income from private sources.

The corporate pension plan will play a key role in this revised social contract, and the quest for higher investment returns portends growing dependency on overseas economies to grow seniors' retirement assets. In particular, there will be a rising attention to issues of pension reform and corporate governance. Exacerbating this trend are recent changes in accounting standards taking place around the world. In the past, tax authorities were the primary influence over corporate pension plans and behaviors, but their purview was understandably focused domestically on tax receipts and consumption behavior. In contrast, in the future, accounting regulators have a broader, global mission to benefit all users of financial information – stakeholders that cross national borders and traditional tax jurisdictions. According to the US Financial Accounting Standards Board (2005: 1), one important aspect is to "promote the international convergence of accounting standards concurrent with improving the quality of financial reporting."

This enhanced corporate financial reporting surely helps correct informational asymmetries and transaction costs that have plagued financial reporting in the past, particularly regarding corporate pensions. But, in turn, this disclosure influences corporate behavior and investor decision-making, having a measurable impact on corporate valuation. In addition, these accounting changes set off and signal a period of more fundamental corporate restructuring as companies respond to the new accounting standards as a chance to reorganize and drive deeper financial reforms.

Against this background common to both Japan and the US, it is useful to compare how pensions in Japan have changed as that country emerges from its restructuring efforts, to the US which is now initiating new pension reform. A common tension characterizes the business environment in both countries, on the one hand seeking to preserve the current pension system, and on the other, building corporate integrity, trust, and competitiveness through reform, increased transparency, and good governance. On the national level, there is also a clash of power among government, political leaders, regulators, corporations, media, and labor which is producing unique reforms. At the same time, globalization of capital flows and competition, as well as regional investment shifts imposed by changing demographics, increasingly necessitate that national pension systems become more easily translated. These forces are working together to remold and align corporate pensions against the backdrop of this century's demographic revolution.

Impact in Japan: Half Financial, Half Personnel.

In 2000 at the low point of Japan's so-called "lost decade,"[2] pension accounting standards were introduced, and subsequently became a tool leveraged by Japanese companies to alter the employment contract. Of course, the CFOs of Japanese companies needed to grapple with pension accounting standards and new requirements for on-balance exposure of pension reserve liabilities. However, concurrently, many companies sought to shift away from the rigid steepness of the seniority-based lifetime employment contract. In particular, corporate executives viewed a shift to the flatter flexibility of a performance-based wage profile as a key restructuring prerogative.[3] Inextricably linked to the rigidity of the old employment contract was the traditional Defined Benefit (DB) lifetime pension model; restructuring pensions then became linked to finding a solution. Accordingly, beyond mitigating the immediate financial risk that underfunded DB plans posed to corporate balance sheets, companies also sought to change pensions so as to accomplish broader personnel initiatives. This included realigning employee incentives under performance-based measures, increasing the transparency of compensation costs and benefits, and fostering self-responsibility for post-retirement planning. In sum, implementing the new pension accounting standards in Japan led to the integration of these complementary personnel objectives while at the same time reducing corporate financial exposure.

Accelerating the Shift Away from Traditional Pension Plans: The US Impact

Defined Benefit (DB) plans in the US have been traditionally concentrated in unionized and mainly manufacturing industries, sectors where employers retain workers for long periods of time and expect to honor lifetime employment contracts. The DB plan then becomes a mechanism to attract and retain employees and, in many cases, to induce early retirement. Yet these are also the sectors characterized by low or even negative growth over the last four decades. And in the higher growth economic sectors, Defined Contribution (DC) plans proved popular for more fluid labor markets where long-term worker retention was no longer considered paramount (Mitchell, 2005).

Pension accounting changes are re-emerging in the US, partly attributable to the recently passed Pension Protection Act (PPA) of 2006. While these changes are being phased in slowly, it is nonetheless clear that the PPA will accelerate two developments underway for some time. First, there has been a long-term trend toward freezing of traditional Defined Benefit (DB) plans in favor of Defined Contribution (DC) or hybrid plans. Second, there has been a trend of re-allocating pension assets towards longer-duration bonds (Berner, 2006; Berner and Harris, 2005).

One feature of the US system that is notably absent in Japan is the Pension Benefit Guaranty Corporation (PBGC), the government-sponsored insurance entity created under the Employee Retirement Income Security Act (ERISA) of 1974. This is a guarantee program to protect workers with vested DB pension benefits. It has been charged with creating moral hazard since DB sponsors do not bear the entire default risk of their plans and it has permitted persistent benefit underfunding. The government has sought to mitigate these problems with minimum funding levels, premiums assessed to insure the companies' obligations, and tax break incentives to companies to pre-fund their plans.[4] But the system has proven unable to keep up, and the PBGC is currently facing billions of dollars of underfunding (United States Government Accountability Office (GAO), 2006).

Over the long haul, the continuing movement away from traditional DB toward DC plans will eventually remove corporate funding exposure. This evolutionary process of courses places on workers' and retirees' shoulders the responsibility to save, manage interest rates and investments, and protect against longevity risk. In the US, the social costs of this shift have become an impetus for pension legislation. As James Wooten (2006: 4) notes, "the PPA [Pension Protection Act] includes provisions that attempt to make 401(k) plans better vehicles for retirement savings by expanding participation, increasing contributions, and improving investment management." Whether the PPA will ultimately lead to the strengthening of the DB system, or whether it will tip the scales away from DB plans, is still in question. Yet many believe that simpler, more transparent, and leaner DC pensions will become the plan of choice for US companies.

The Japanese Reforms: Looking Back and Looking Forward

Traditional DB pension plans in Japan came under scrutiny with the introduction of pension accounting standards in the year 2000. At the time, companies were faltering under the weight of underfunded pension liabilities and persistent recessionary trends (*Nikkei Business*, 2003). Expectations ran high that the Defined Contribution Act of 2001 would provide necessary relief and set off a wave of plan conversions from traditional DB to new DC plans.

Yet, it soon became clear that the wide-scale adoption of DC plans, modeled after the US 401(k), would not occur. The negligible shift towards DC plans is attributed by some to a corporate commitment to long-standing employment contracts and a paternalistic culture. Under that view, benevolent corporate managers might foresake change to uphold their DB promises to the bitter end, even at the cost of insolvency. But this interpretation is inconsistent with Japanese companies' lobbying effort for further deregulation and their public stance in favor of DC plans. As seen in Figure 1, many employers terminated their Employer Pension Funds (EPFs) from 1995, with noticeably higher termination rates from 1999 until the time of the pension reform legislation in 2001-2002. In other words, companies were not standing behind paternalistic norms or lifetime employment contracts even before the DC legislation was enacted. To make sense of the lukewarm response to the Japanese DC innovation, we take a step back and consider what happened just prior to the reform.

Figure 1 here

Evolving Tradition. The tradition of corporate pensions in Japan can be traced back to the Edo period (1603-1867), when tradesmen provided employees with a lump-sum retirement allowance in recognition of long years of service. Eventually, this custom evolved into a supporting pillar of the lifetime employment contract. Embedded as such, the notion of pensions as a reward for long service proved difficult to discard at the bursting of the "Bubble." An unfunding (or underfunding) of pension assets was consistent with the lifetime employment contract concept because payouts were withheld until retirement. Moreover, nonfunding was consistent with the tax treatment of contributions and benefits, a common driver of funding levels across countries.

When corporate pensions formally developed in Japan after WWII, the tax rules did not allow companies to expense current contributions or assets set aside for pre-funding. That is, strictly speaking the rules did allow it, but they also required an offset to the employee in the form of a current tax obligation regardless of whether the employee was actually receiving any benefit then or 30 years from then. To maintain labor harmony, companies typically made concessions to workers which would exactly offset their current tax burden. As a result, companies found it more convenient to simply not pre-fund their DB pension promises.

Given the youthful employee base and favorable economic times, the unfunded system worked smoothly for many years with minimal cash or funding risk. As the employee base aged and the recession deepened, the system revealed its flaws.

The Slow Shock: Demographics. The true extent of Japan's demographic woes began to emerge in the 1990s when the inadequacy of the public pension system became apparent. Medical advances and standard of living improvements had elevated Japanese longevity to the highest in the world. At the same time, economic changes and societal trends were favoring smaller families and lower fertility rates. The public system's Pay-as-you-Go (PAYG) structure, which finances retiree benefits primarily from active worker taxes, became viewed as no longer sustainable compared to the post WWII period. The interplay of demographics and pensions can be best understood by comparing the population age distribution pyramids in Figure 2.

Figure 2 here

The dramatic demographic shift has meant that the PAYG public pension system will have difficulty fulfilling benefit promises to an expanding base of retirees while the contribution base is shrinking. To make matters worse, benefit promises had been raised considerably during the high-growth period in a deliberate effort to share the fruits of the period with those no longer in the workforce. Finally, the growing government deficit that emerged in the aftermath of the bubble economy is unlikely to result in a government bailout. In other words, the threat of public pension insolvency has put increasing pressure on corporate pensions to take on a greater role in Japan's retirement equation.

The 'Big Bang' Shock: Pension Accounting Standards. At the same time, the globalization of accounting standards also puts pressure on Japan to adopt more stringent pension accounting and disclosure requirements. Some deemed Japan's old approach to pension accounting as unfair, a source of hidden liabilities, and a false source of global competitiveness. Adopting pension standards consistent with modern accounting practice, however, requires treating pensions as deferred compensation. This means the operating expense on the income statement and the liability on the balance sheet represent the present charge and net present value of the obligation, respectively (with various mechanisms to smooth the short-term gains and losses over time). Introducing pension liabilities on the balance sheet and disclosing the full extent of pension underfunding in the footnotes made transparent, for the first time, the shaky status of corporate pensions and their inability to assume a stronger role in the three-legged stool of retirement provision (Berner, Boudreau, and Peskin, 2006).[5] In other words, the introduction of pension accounting standards was a shock to the system because it heightened awareness over the need for corporate restructuring.

The Restructuring Corporate Challenge. Even companies which wanted to restructure found that the Japanese tradition of a lifetime employment contract made it difficult to do so nimbly. Procedural and legal red-tape governing layoffs, as well as the associated social stigma, reinforced labor market rigidity and encouraged firms to freeze hiring instead of laying off existing employees. At the same time, the traditional lifetime employment contract implied a steep lifetime salary profile, so many companies wished to replace seniority-based increases with pay-for-performance metrics, particularly as Baby Boomers aged.[6] In terms of pensions, the overhaul or redesign of a pension plan was far from simple, especially when it was needed as an element of a broader personnel initiative to revise the lifetime employment contract.

Meanwhile, a so-called "perfect storm" was brewing in the Japanese macro-economy, bringing with it serious consequences for companies with DB plans struggling under the new pension accounting standards. Near-zero interest rates reduced the discount rate used to calculate the pension benefit obligation (PBO), while low investment returns reduced actual and expected returns on pension plan assets. Taken together, these factors expanded pension underfunding and further exacerbated low margins at Japanese companies.[7]

The urgency created by new accounting standards made apparent certain inadequacies in the system: 1) "*daiko henjo*", or the putback of the government portion of the company's DB plan; 2) options to convert rather than dissolve DB plans; and 3) an improved safety net for retired beneficiaries. Solving these problems proved difficult.

Political Deadlock. Discussions about DC plans surfaced in 1996 under the Hashimoto Cabinet. At the time, Prime Minister Hashimoto garnered hope from the U.S. example and the spectacular growth of DC or so-called "401(k)" plans.[8] While in the US, 401(k) plans provided a mechanism to stimulate savings, debate over DC legislation in Japan was launched just when the nation's saving rate was under foreign criticism for being too high and its imports too low. This political beginning and deference to the U.S. model were considered fatal flaws by some in the bureaucracy who viewed this as a serious miscalculation of the complexities of pension reform (Wakasugi, 2003; Yano, 2003).

By the time the Japanese Diet passed its DC law, it was 2001 and three cabinets later, with the country now led by Prime Minister Koizumi. At that point, expectations had both soared and soured. Many US entrants from the 401(k) business had cut their losses and pulled out of Japan. Companies and market participants had been disappointed several times with delays and issue reprioritization (McLellan, 2005). Even some confident that the reforms would eventually pass were aware that Japanese politics might change the law in the final hour. Accordingly, most companies preferred to wait before implementing any massive plan design changes. For example, even IBM, with its vast experience implementing DC plans around the world, lamented over how it had to move slowly as a result of the uncertainty and ambiguity associated with the timing and eventual form of the legislation (Roin, 2003; Tsubota, 2003).

When the DC Act was passed, it disappointed many. In its original form, the maximum contribution limit had been set at ¥432,000 (approximately $3,600) per year for employees of companies lacking alternative pension systems, and ¥216,000 (approximately $1,800) per year for employees with other types of pension plan offerings.[9] These caps meant that many companies could not fully convert existing plans. The DC legislation also prohibited early withdrawals (before age of 60) and did not permit employee contributions. This kept the assets small and locked-in. By contrast, the U.S. 401(k) system integrated more features of a tax-deferred saving system based on employee contributions primarily, with employer-matching pension features secondarily. Also, the US maximum annual contribution limit for individuals at that time was much higher, at $10,000. Withdrawal exemptions further helped employees liquidate or take a loan against their pension assets under special circumstances such as higher education, first-time house purchase, or financial duress.

The form and timing of the Japanese DC legislation suggest not that paternalism held sway, but rather that other factors came into play. At the same time, the Japanese pension legislation undoubtedly influenced the overall picture of corporate pension reform. The changing pension accounting standards began to tip the scales in favor of difficult restructuring programs and eventually even employment contracts began to be revised.

Unintended Consequences. The low contribution caps set forth in the DC legislation prevented many Japanese firms from fully converting their existing DB plans to DC plans, so some firms have turned instead to Cash Balance (CB) plans. These are a hybrid plan type permitted under the Defined Benefit Occupational Pension Act of 2002, and they appear to be a good "fit" for many companies as they combine good features of both pension structures. For instance, the CB accrual pattern is flatter than in a traditional DB plan, so the common restructuring goal of reducing the steepness of the seniority-based wage curve in favor of performance-based mechanisms could be achieved with this new tool. Furthermore, CB plans are consistent with the historically appropriate Japanese shared-burden or compromise approach to problems.[10]

Since DC plans lack the positive personnel attributes of DB plans and shift the entire investment risk to employees, they are not necessarily a win-win for all employers and employees. Older employees, in particular, are less familiar with making personal investments, so the learning curve and risk aversion associated is large. Soft freezes, which let older employees remain in the DB plan but close entry to younger workers, has the effect of speeding up the cash requirements since the plan is primarily paying out benefits. The transition to a DC plan is complex requiring the expertise of pension consultants and actuaries. Within the company, an employee public relations campaign must be followed by investor education programs.[11]

Nevertheless, some industries prefer DC plans because of high-levels of turnover and a younger employee base that responds well to investment and self-responsibility (Shimizu and McLellan, 2006). This is true for instance in the retail sector, which has benefited from some lobbying by the business community. In October of 2004, the maximum allowable nontaxable contribution by employers was boosted considerably, and the following year, the restrictions on withdrawals were relaxed. As of the end of June 2006, over 7000 companies had introduced DC plans in Japan, up 51 percent from the prior year (*Nikkei Shimbun*, 2006). DC adoption rates are also higher at smaller companies because they lack the scale and resources required to set up and manage a DB plan. Many of these companies also face a looming deadline for their tax-qualified pension plans (TQPP) facing extinction in 2012. For these companies, DC plans still offer an attractive conversion option.

Looking Ahead: the 2007 Problem. In overview, the recent pension restructuring patterns in Japan can be seen with some optimism. The economy is emerging from a prolonged recession and Japanese corporate pension have restructured in important ways. Yet the so-called "2007 problem" looms, which is when Japan's Baby Boomers begin to retire *en masse*. Over one-third of firms deems this "a crisis," and over 80 percent of firms plan countermeasures (Ministry of Health, Labour, and Welfare, 2006). Specifically, hiring and retention are becoming increasingly important given anticipated talent shortages, and DB plans seem to offer an effective HR management tool that DC plans do not. In other words, Japanese corporate pension plans may continue to be reoptimized, to assist human resources strategy rather than simply managing balance sheet liabilities.

Turmoil in the US Pension System

In the US, the last five years have been a period of negativity and crisis-mongering in the pension arena, leading many firms to re-evaluate their plan offerings. Between 2000 and 2004, equity returns were terrible, and, coupled with low interest rates, DB pension funding sank. These shifts brought about the need for change in pension plan regulations and pension management, and disclosing the true unfunded liability on the balance sheet rather than burying it in the footnotes.

The general thrust of recent regulatory and oversight has been to clarify discrepancies between plan assets and promises made to current and future retirees. The Financial Accounting Standards Board (FASB) recently proposed amending the US Generally Accepted Accounting Principles (GAAP) to require companies to eliminate pension smoothing on their balance sheets and disclosure of pension obligations. Over time, FASB will seek to align US standards with the International Financial Reporting Standards (IFRS) adopted by the International Accounting Standards Board (IASB). In general, the effort has been to mark-to-market both pension assets and liabilities. In response, some firms have already frozen their existing pension plans while others have switched active employees to DC plans.

In addition, legislation is in place to reshape existing DB plan funding rules, making it more difficult for most firms to let their plans evolve to a precarious state.[12] New funding requirements also reduce smoothing, accelerate amortization of past costs, and increase premiums per beneficiary. The goal is to shore up the PBGC which is now facing substantial shortfalls. This new legislation will have some short term impact on companies, but its impact will ultimately compound reforms in financial reporting and capital market pressures to force companies to make more structural changes. For example, in the wake of other scandals, rating agencies are scrutinizing more carefully how they treat unfunded post-retirement liabilities of all sorts. Lowered ratings will surely increase borrowing costs down the road, particularly if rating agencies count the DB plan equity exposure as a form of corporate leverage. Specifically, additional risk would be seen to arise from mismatches in the duration of the plan assets returns relative to the expected time frame of beneficiary payouts.

Conclusions

Corporate pension plans in both the US and Japan face substantial challenges which are demanding new strategies. Future reforms will respond to accounting standards and pension reform legislation, as well as corporate governance pressures. For instance, proactive management teams will need to take pension financing into account when making overall corporate finance decisions, including more tax efficient funding and trading strategies. Companies will also deem it necessary to hold more fixed income and alternatives, versus equities, as part of a move towards a more sophisticated approach of matching DB plan assets against liabilities. These strategies may be useful in preserving the DB plan structure, whereas those who freeze DB plans or establish only DC plans, may find they cannot well address the risks worrying workers and beneficiaries. A related point is that DB plans may become increasingly useful in addressing long-term HR objectives, a goal that we expect to become important in an aging world.

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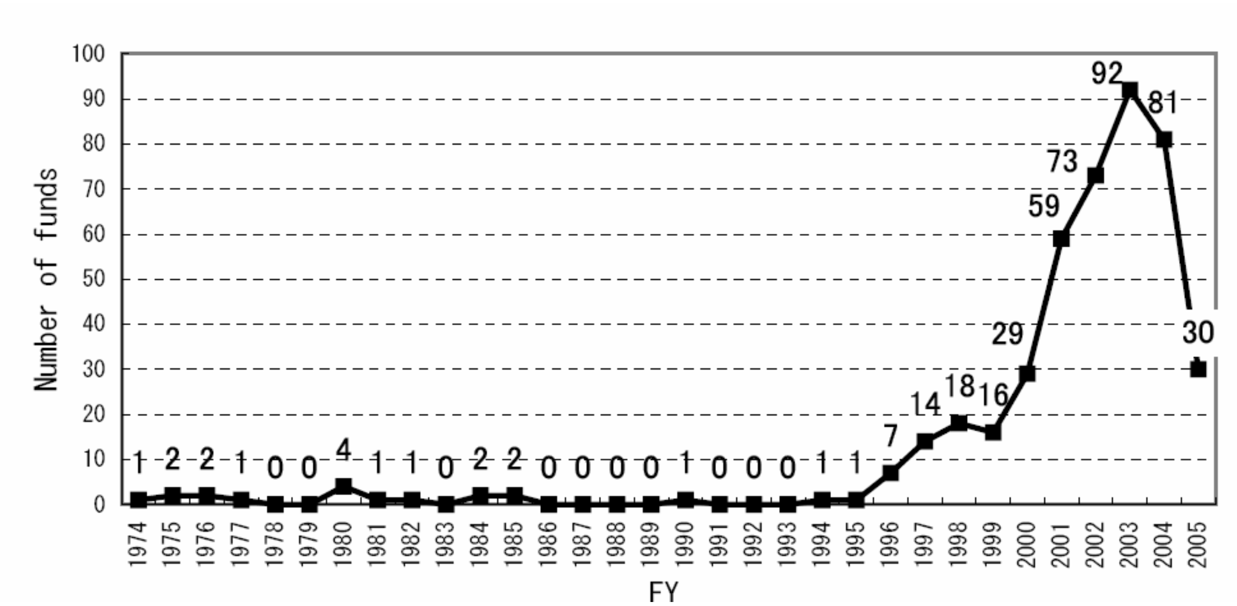
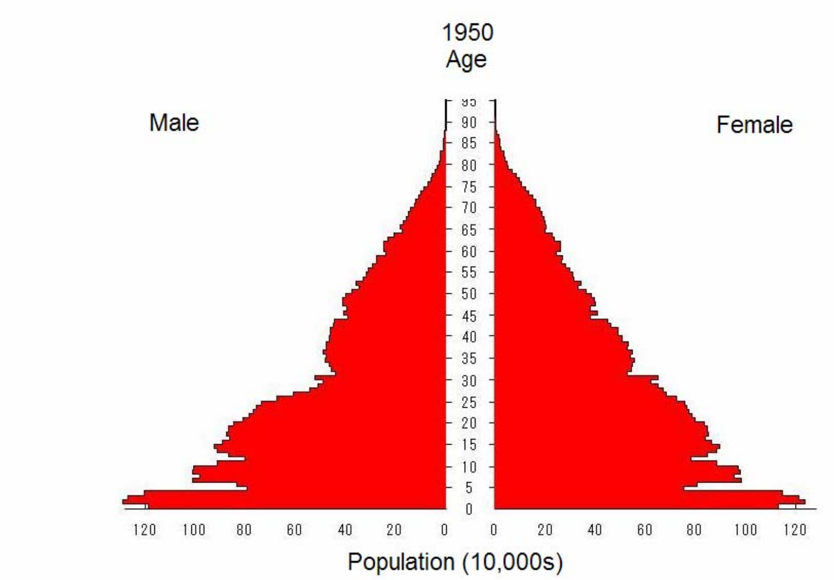
Figure 1. Number of Terminated Employee Pension Funds (EPFs)

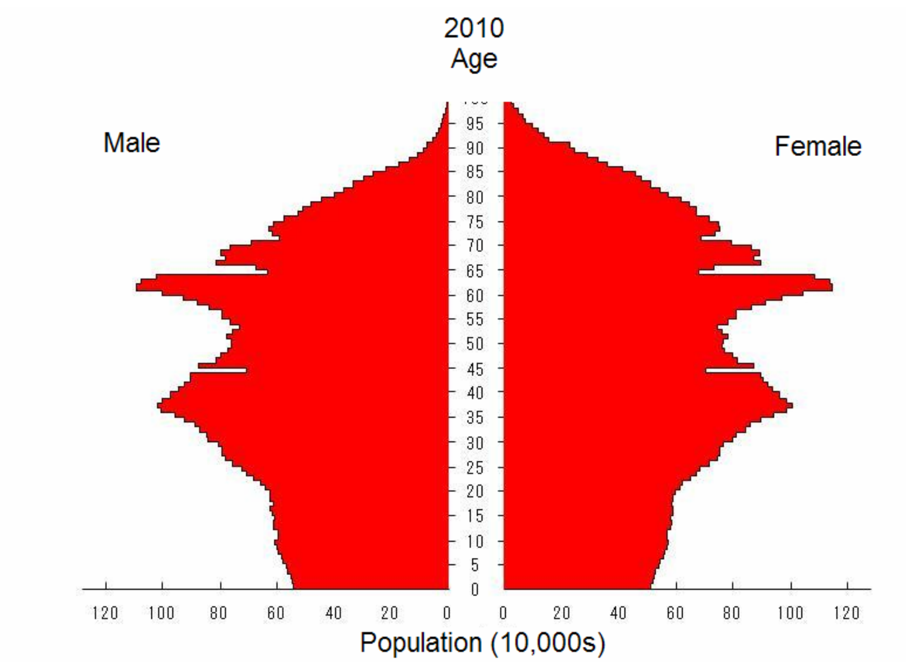


Source: Pension Fund Association, 2006.

Figure 2. Distribution of Japanese Population by Age: Demographic Pyramids
a) 1950



b. Projected for 2010



Source: National Institute of Population and Social Security Research (2006)

Endnotes:

[1] This term refers to the ratio of the working-age population (age 15-64) to persons 65+. In 1950, there were 50 working age persons per older; by 2050, the ratio is expected to drop to 2.5 to 1 in the US, and just 1 to 1 in Japan (Siegel, 2006).

[2] The "lost decade" in Japan refers to the period of economic stagnation following the bursting of the bubble.

[3] Underlying this was the structural shift of ownership structure and, specifically, the shift from a dominant bank governance model to an increasingly foreign-based shareholder ownership structure (McLellan, 2006).

[4] Under the Japanese commercial code, companies do not have the same incentives and can legally operate some types of pension plans highly underfunded without penalty (or safety net).

[5] The three-legged stool represents i) corporate or public pensions, which defer compensation; ii) personal saving, in which individuals defer consumption; and iii) the government safety net, which makes promises based on future economic growth. (Berner, Boudreau, and Peskin, 2006).

[6] In a traditional lifetime employment wage model, younger employees were paid less than their contribution in the early years of employment to induce retention. As older employees, they would recoup the "lost wages", but in effect, the company was paying back a loan to employees at a cost higher than their current productivity.

[7] Near-zero rates indicate that the present value and the future value of the labor obligations are almost the same making the obligation much more "near-term". In comparison, US companies calculate pension obligations on rates roughly 650 basis point higher. This difference indicates that the risks of cash flow requirements are more short-term oriented in Japan, all else equal.

[8] DC plans became popular in the U.S. starting in the late 1970s after Congress added §401(k) to the tax code (1978) and the US Treasury issued regulations outlining their requirements (1981).

[9] Based on October 2001 levels (approx $1 = ¥120).

[10] Cash balance plans have been controversial in the US due to allegations of age discrimination. However, recent court decisions have reversed some of the controversy, providing hope that hybrid plans may once again gain favor among US companies (United States Court of Appeals for the Seventh Circuit, 2006).

[11] Plan conversion requires union approval or two-thirds employee consent.

[12] Some industries such as airlines still receive special breaks (i.e. amortization periods and funding durations extended), indicative of political willingness to continue to subsidize non-competitive industries.