Japan’s Reform of Its Pension System for Sustainability

By Yuji Kage

Introduction

Japanese corporate pension funds have experienced a severe crisis since the mid-1990s due to the country’s long-term economic stagnation, which has meant both poor investment performance and low interest rates that have expanded future pension liabilities. In spite of such difficulties, however, the system is still alive.

Many major corporations injected billions of dollars’ worth of additional contributions to save their defined benefit (DB) pension plans. Furthermore, sponsors and unions agreed to modify the existing pension promise. They changed the actuarial structures—including the reduction of benefits for pensioners—to avoid termination of the funds.

Reflecting the quite serious prospects of an aging society, Japanese public pension funds also faced serious problems and were substantially reformed in 2004, through a reduction of benefits and an increase of contributions with additional government aid. Although actuarial assumptions of the current system indicate sustainability for 100 years with more than two times reserves against the total amount of annual benefits, the Japanese government recently started to consider another round of its fundamental reform.

Japanese pension funds have been criticized continuously as too risk-averse. There have been occasional recommendations that these funds take more risk to save the pension system. However, the low-risk investment policy has been an effective strategy for sustaining the pension system over the past decades of economic difficulty. In fact, the above criticism has not been convincing because it ignores potential significant losses that could kill the pension funds.

Pension funds in the western world now face growing concerns similar to Japan’s as a result of aging populations and the recent global economic crisis. A number of corporate pensions have been frozen or closed for new hires, particularly in the United States and the United Kingdom.

How to reform the pension system for sustainability is one of the current major social, political, and economic agendas in many developed countries. Governments, political leaders, and pension experts are desperately looking for solutions to sustain existing pension systems. But if you do not find the right answer at all for a specific question, the question itself may not be the right one. It is worth reconsidering the question about the sustainability of the “conventional model” of a pension system. It appears some people have gradually started to think about it.

This article presents the details (with examples) of Japan’s pension reform; examines the subject of managing investment risk in order to attain pension system sustainability; and discusses the implications that Japan’s experiences may have for other systems facing similar challenges.

How Japan Has Kept Defined Benefit Pension Plans during the Economic Downturn

The recent history of Japan’s pension system is discussed below, including details of the reform of the past decade and specific examples of this reform. Japanese pension reform essentially modified the concept of the defined benefit plan. This was accomplished by introducing some flexibility to the defined part of the plan by allowing for reductions in benefits as an alternative to closing a plan.

The Japanese Corporate Pension Crisis of Early 2000

Japan experienced a long-term economic downturn from the early 1990s through the early 21st century. The Tokyo Stock Exchange lost about 80 percent of its value and the urban real estate market also lost 90 percent from its peak. Interest rates continue to crawl around 0 percent.

In this extreme environment, the average funding ratio of corporate pension funds at the end of fiscal 2002 fell to 67.7 percent. Ninety percent of 1,800 funds showed underfunding of more than 10 percent (PFA 2004).

By unlucky coincidence, Japan introduced new accounting rules for corporate pension funds effective April 1, 2000. This was the worst time for Japanese companies: Profitability hit the historical low and many companies recorded huge losses.

The new accounting rules required the following:

- To recognize the underfunded amount of corporate pension funds (as well as the lump-sum retirement allowance) on a company’s balance sheet every year.
- To amortize this amount on annual profit and loss statements, together with any additional amount generated every year.

The aggregate underfunding for all of corporate Japan was estimated at ¥20 trillion—¥30 trillion (equivalent to roughly $170 billion—$250 billion). For each major company, the required injection amount reached a few hundred billion yen (roughly a few billion dollars).

Action Taken by Japanese Corporate Pension Funds

In response, corporate pension systems took the following actions:

Pension plan closures. Of 1,800 total funds, 334 closed between 2000 and 2004 (PFA 2004), despite corporate and union efforts to retain the plans.
Additional contributions. Many big corporations were obliged to contribute extra—on the order of billions of dollars—to make up the underfunding (Usuki 2001).

Cutbacks of future pension benefits for current workers. By the end of fiscal 2001, 366 among the total 1,800 funds had decided on this reduction (Nihon Keizai 2002).

Cutbacks of existing pensioners’ benefits.

In line with private-sector efforts, the Japanese Ministry of Health, Labor and Welfare (MHLW) actively facilitated these developments. MHLW created rules to permit the cuts in pension benefits under special conditions and enacted new laws to introduce a defined contribution plan and cash balance plan in 2001. It also allowed companies to return the Daiko portion of pension plans and created a new type of corporate pension plan.

As for the new accounting rules, MHLW decided to allow unfunded liabilities to be amortized over a period of between three and fifteen years (PFA 2004).

How Government Approved the Reduction of Benefits for Pensioners

Pension funds became a significant problem for corporate executives, and major corporations began lobbying quite actively to develop a reform package. Indeed, some major companies started to close their pension plans because closure was legally easier than reducing benefits. This situation motivated corporate executives and government officials to work effectively on pension reforms.

Corporate sponsors must get MHLW approval to change a pension contract, including any reduction in pension benefits. MHLW’s rules regarding reduction of pensioners’ benefits for exceptional reasons are summarized below (Higuchi 2010).

A. The board of directors for the pension plan must formally agree to the reduction; so must the union, if one exists.
B. There must be a sufficient process in place to explain the change in benefit to all the pensioners.
C. At least two-thirds of pensioners must agree to the reduction.
D. The pension plan must arrange for payment of the present value of future promised pension benefit for those who choose a lump-sum payment.

MHLW’s decisions are guided by a policy to support pension subscribers’ rights as long as the sponsor is on reasonably good financial footing. Between 1997 and the end of March 2011, 889 corporate pension funds of 1,800 total reduced the future benefits of participants; 69 funds reduced the benefits of pensioners (P&I Japan 2011a).

Examples: Pension Plans that Reduced Pensioners’ Benefits

Shinkin Bank. This is the fund for all the employees of small regional financial institutions throughout the country and it is the largest corporate pension fund in Japan. It cut pensioners’ benefits by one-third, with the support of 82 percent of subscribers (including pensioners) in 2003 (Asahi 2003). In fact, the choice was between termination of the plan or cutting back one-third of the benefit. No doubt, most of the employees and pensioners chose the latter simply because two-thirds is much better than nothing.

Japan Airlines. After filing for bankruptcy protection in early 2010, the Japan Airlines (JAL) trustee applied to MHLW to reduce workers’ benefits by about 50 percent and pensioners’ benefits by about 30 percent. JAL’s pension troubles were widely publicized, and the government and the banks—which were supporting the airline’s daily cash flow—favored the reductions. Indeed, it looked like the JAL pension fund would be terminated unless such reductions took place. Public opinion also favored the reduction plan and criticized its opponents because the pre-reduction benefits were quite generous: ¥5.8 million per person compared with the average corporate pension of ¥3.5 million per person (Yahoo News 2009). Reportedly 95 percent of workers and 72 percent of pensioners accepted the proposal despite aggressive opposition by some activist union members. MHLW approved this application in March 2010.

NTT. In February 2006, MHLW rejected the application of NTT, Japan’s major telephone company, to reduce pensioners’ benefits, despite the fact that the reduction was approved by more than 120,000 of the company’s 145,000 pensioners. MHLW argued that NTT’s annual profit of ¥100 billion did not justify the reduction. NTT filed an administrative litigation against MHLW on the basis that more than two-thirds of pensioners had accepted the reduction. After judgments by regional and appeals courts against NTT, the company went to the Supreme Court. In June 2010, the Supreme Court rejected NTT’s appeal and the planned cut of benefits has not taken place.

Bunka Shatter. In 2011, the mid-sized company Bunka Shatter reduced pensioners’ benefits. This case is surprising because the company wasn’t terribly in the red: It had just returned to profitability after two years of losses. This decision is interpreted as an example of how MHLW’s judgment in these cases is flexible (P&I Japan 2011b).

What made these changes possible?

In most developed countries it would be out of the question for the plan to cut pension benefits. Why were these reductions possible in Japan? There are three major reasons:

Social and cultural factors. Major companies in Japan still have the lifetime employment system and retired employees feel some solidarity with working colleagues, although things gradually have been changing. Pensioners could not refuse the proposal to share the pain when the working generation suffers reductions in salary and bonuses.3

Labor unions. Unions in Japan are not craft unions. They are established for each company and union leaders generally share a common interest with the management in the long-term sustainability of the company; Japanese unions demonstrate greater loyalty for employers than do their western counterparts.
Lack of a clear legal concept of vesting. Although retirement allowances (including pension funds) are considered to be a delayed payment of salary and bonus, Japan has no legal concept of “vesting.” In addition, Japanese culture accepts a somewhat flexible interpretation of force majeure, which makes it possible to change a promise when the environment and related assumptions significantly change.

For these reasons, many Japanese employers, employees, and pensioners have chosen to accept a reduction of benefits in exchange for a pension plan’s sustainability after the original promises became unrealistic.

2004 Reform for Sustainable Public Pension System
The Japanese public pension fund is more secured than generally perceived. It carries a huge amount of reserves, the equivalent of $1.4 trillion, although the country is facing more serious challenges of an aging society than many other western counterparts. In fact it is reported that the reform of 2004, which includes gradual trimming of the benefit, would make the pension system sustainable over the next “hundred” years.4

The reform of 2004 accomplished the following, from the MHLW website, http://www.mhlw.go.jp:

• Set the ceiling for worker contributions at 18.30 percent (in 2017), gradually rising from the current 15.35 percent.
• Gradually cut the ratio of the pension benefit to the average worker’s income from the current 62.3 percent to 50 percent in 2038.
• Use the reserve to cover the cash flow of benefit payments each year. After 100 years, the reserve should be sufficient to cover the payment of one year.
• Raise the government contribution from the current one-third to 50 percent.

Needless to say, sustainability of the next 100 years is the simulation based on various actuarial assumptions, and in fact, the return assumption was raised from 3.2 percent to 4.1 percent in 2009. Like many developed countries, Japan should continue its reform for keeping the public pension fund system, reducing benefits and raising contributions in the long run.

Implication of Pension Reform in Japan
Japanese corporate and public pension funds generally gained more stability against the aging and volatile market environment. Corporate funds are prepared for more strict actuarial/accounting regulatory pressures. The damage caused by the global financial crisis of 2008 seemed relatively less in Japan, and many corporations still keep a defined benefit pension plan and will keep it for the future.

Risk Management of Investment to Achieve a Sustainable System
Over the past several years pension funds in the western world also have faced serious challenges. This is particularly so in the United States and the United Kingdom because funds in those countries assume a higher rate of investment return, say, 7 percent–8 percent. These funds take higher levels of risk, allocating around 60 percent of assets to equities, to accomplish such objectives. Given the current volatile market conditions and gloomy economic prospects in developed countries, this high-risk policy turned out to be a major cause of the pension-funding problem. Now we are seeing noticeable trends of de-risking in many pension funds around the world. In this context, it should be helpful to learn about the Japanese experience.

Risk management of pension investments—especially the decision about what is the appropriate level of risk—is key to the sustainability of a pension plan. Given stricter regulations and accounting rules on top of today’s difficult economic environment, some pension funds are (or are considering) reducing risk exposure. Others still take higher risk for higher return. Their supporters emphasize that Japanese pension funds are ultra-conservative and should seek higher returns in view of Japan’s unfavorable demographic trends.

In this section, the risk management of both public and corporate pension investment in Japan is discussed and illustrated with examples.

Risk Management of Japan’s Public Pension Fund
Japan’s Government Pension Investment Fund (GPIF) is the world’s largest, with approximately $1.4 trillion in assets as of the end of 2010—three to four times as large as the gigantic funds in western counterparts such as CalPERS, ABP, and Norwegian Fund (GPIF website, http://www.gpif.go.jp/en). GPIF is invested in a conservative manner. The long-term expected rate of return is currently set at 3.2 percent per annum, and to accomplish this objective the policy asset mix is currently set as shown below. (Note that total equity is only 20 percent, which means a quite risk-averse strategy.)

• domestic bonds: 67 percent
• international bonds: 8 percent
• domestic equity: 11 percent
• international equity: 9 percent
• cash: 5 percent

The long-term investment return objective of 3.2 percent is designed as 1.1 percent above the nominal wage growth rate of 2.1 percent. This means as long as the long-term average investment return is more than 3.2 percent, payment of the real value of benefits should be secured for the long term. As a result of this modest goal, it has been possible for GPIF to invest its major portion in Japanese government bonds. (In 2009, this 3.2 percent was revised to 4.1 percent, but the return objective remains unchanged. See section below, “The Need to Reconsider the Pension Promise.”)

Should GPIF Change Its “Risk-Minimizing Culture”
Keith Ambachtsheer (2007b), the distinguished Canadian pension consultant and editor of the International Journal of Pension Management, pointed out that GPIF is governed
by a "cost and risk minimizing culture" and should consider changing to a "high performance culture." All other factors being equal, higher investment performance is, needless to say, much more desirable. However, the change may not be meaningful and/or feasible, at least for the time being.

Three reasons to support GPIF’s existing low-risk policy are the following:

1. **The fundamental character of public pension funds.**
   GPIF is governed by the MHLW. Like many other countries in the western world, Japan’s public pension system is strongly influenced by politics because its key parameters are decided at the parliament. When its investment return falls negative for a few years, citizens, the media, and politicians tend to loudly criticize the MHLW and GPIF. It’s natural for the MHLW and GPIF to consider such political pressure when creating investment policy; human beings tend to be short-term oriented, as Charles Ellis continues to argue (Ellis 2010). This short-term reality likely represents the ultimate limitation of how public funds can be managed in democratic countries. This is a major reason to choose a low-risk strategy. GPIF investment policy is also influenced by government fiscal policy, explicitly and implicitly. This is understandable because taxpayers ultimately are responsible for the present and future payment of pension benefits. In Japan, 50 percent of annual public pension benefits are financed by the government budget. A 67-percent allocation to domestic fixed income, mainly Japanese government bonds, is in line with this influence.

2. **Cultural background.** The Japanese people are basically risk-averse. Ninety percent of the country’s ¥15 trillion in individual savings is deposited with banks/post offices and insurance companies and only 10 percent is invested in stocks and mutual funds (Bank of Japan 2009). This risk-averse bias is reflected in the opinions of the general public, the media, and politicians. A market-oriented thought process, including theory of portfolio management, policy asset mix, and risk-and-return characteristics, gradually has been introduced for the professionals over the past few decades, but it still has a long way to go with the general public.

3. **Issue of size.** With GPIF’s assets under management at approximately the equivalent of $1.4 trillion, even a 1-percent change in allocation means a transaction of about $14 billion. This most likely would create a significant market impact that may negatively affect return. Thus it’s impractical for GPIF to consider the same active investment strategy as the funds with $200 billion–$300 billion and therefore some 80 percent of its portfolio is invested passively. Indeed, size is a major obstacle to accomplishing more-effective investment (Tamaki 2004). As a rule of thumb, $300 billion–$400 billion would be the maximum practical amount to consider for portfolio management with proper risk-and-return-characteristics.

In view of political/cultural constraints and the size issue, GPIF’s low-risk investment policy seems to have worked relatively well in Japan’s difficult economy. This approach seems to be in line with the opinion of the majority of Japanese people for the moment and likely will not change in the short term. Furthermore, it does not make sense to try to change the return objective because it is a part of the entire actuarial assumption described above. A higher return objective would require revision of the entire actuarial structure.

Thus potential fiscal-policy changes may drive future public pension fund reform. Japanese government debt is approaching 200 percent of gross domestic product (GDP), and although Japan’s interest rates are the lowest in the world, this situation will not continue forever. Inevitably the government will start to consider changing its policy expecting a higher return on public pension fund assets in order to reduce the government budgetary support.

### Agenda for GPIF to Reconsider Its Current Investment Policy

As discussed above, the current low-risk investment policy of Japanese public pension funds has been created and supported by actuarial requirement, political/cultural factors, and consideration of the size issue. That means it would not be easy to change the low-risk investment policy unless these factors change. In fact, it seemed to have worked relatively well under the difficult Japanese economy over the past decades.

However, in 2009, at the formal every-fifth-year review of the appropriateness of the actuarial assumption, the long-term investment return assumption for pension assets was raised from 3.2 percent to 4.1 percent. Usually, this actuarial requirement is reflected in the investment policy and policy asset mix. But, this process was suspended then and it was decided that existing policy including a 3.2-percent investment objective was effective temporarily for the moment. It was a coincidence that the Democratic Party of Japan won at the general election and many important policies including the pension system were put for fundamental review.

Change of the actuarially assumed investment return has sent an obvious message that a 3.2-percent return could not arithmetically support the assumed current benefit and contribution structure. A 4.1-percent return is necessary to sustain the current assumptions. All other factors being equal, this basically requires a higher return of investment, which should have a significant impact on GPIF’s future investment policy one way or the other. But before mov-
ing into it, one critical question should be addressed: Is 4.1 percent the realistically appropriate assumption of long-term investment return?

As a 4.1-percent return is primarily established within the actuarial framework, further review from the reality of capital markets is necessary. Historical investment performance does not seem to be supporting the substantial rise of future investment return.

That said, it would be meaningful to reconsider the GPIF’s investment policy within a low-risk framework because there are only three measures to seek for sustainability of pension funds, independently or combined: reduce the benefit, raise the contribution, or increase the investment return.

There should be the following agenda for such purpose.

How to reconcile the actuarial requirement of higher return (whether it is 4.1 percent or something else) and investment policy? Even though the pension-investment time horizon is supposed to be very long, the actual policy decision-making process is substantially affected by the present economic environment (see “Are Pension Funds Really Long-Term Investors?” below). Today’s global economy will continue to struggle for the next several years, which seems to be the worst timing for pension funds to increase risk levels. Many pension funds and institutions all over the world are heading for “de-risking.” At present it would be practical to consider the return objective separately from the actuarial requirement, because the latter is the average figure assumed for the next 100 years. In other words, it would be practical to suspend discussion of a higher-return model until the world economy recovers.

Is the current investment policy and asset allocation realistic to accomplish a 3.2-percent return objective? Although investment by the public pension fund has been in line with the investment policy over the past ten years, the actual nominal rate of return turned out to be 1.4 percent (MHLW 2011). Needless to say it is due to a long-term bearish Japanese equity market and zero rate monetary policy. This means the assumed return of Japanese equity and bonds when the policy asset mix was formed was somewhat higher than the reality.

What are the appropriate asset classes to invest in? A ten-year history of investment performance suggests that the returns of both Japanese and international equity were quite poor (−1.5 percent and 0.9 percent, respectively). Globalization and development of information technology generally provide higher correlation and less benefit of diversification among conventional asset classes and regions. This is one of the major reasons why it would be meaningful for GPIF to consider alternative investments as well, one way or the other.

How to cope with the size issue? As noted above, size is the major problem when heading for higher return. In order to implement the change of investment policy, it is essential to work out this issue. Cutting back the fund to two, one for a conventional low-risk model and the other (say, $200 billion–300 billion) for a new model could be one of the options.

### TABLE 1: DISTRIBUTION OF EXPECTED RATES OF RETURN

<table>
<thead>
<tr>
<th>Expected Rate (%)</th>
<th>Number of Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;1.5</td>
<td>3</td>
</tr>
<tr>
<td>1.5–2.0</td>
<td>10</td>
</tr>
<tr>
<td>2.0–2.5</td>
<td>54</td>
</tr>
<tr>
<td>2.5–3.0</td>
<td>167</td>
</tr>
<tr>
<td>3.0–3.5</td>
<td>165</td>
</tr>
<tr>
<td>3.5–4.0</td>
<td>99</td>
</tr>
<tr>
<td>4.0–4.5</td>
<td>50</td>
</tr>
<tr>
<td>4.5–5.0</td>
<td>24</td>
</tr>
<tr>
<td>5.0–5.5</td>
<td>0</td>
</tr>
<tr>
<td>&gt;5.5</td>
<td>26</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>598</strong></td>
</tr>
</tbody>
</table>

Data: PFA 2010; Survey: July 2010
Coverage: New Type of Corporate Pension, Member of PFA
Meaningful Sample of Corporate Funds except for Multi-Company Type

### TABLE 2: ASSET ALLOCATION OF JAPANESE CORPORATE PENSION FUNDS

<table>
<thead>
<tr>
<th>Asset Allocation of Corporate Pension (%)</th>
<th>March 31, 2000</th>
<th>March 31, 2010 Conventional Type</th>
<th>March 31, 2010 New Type*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japanese Bond</td>
<td>23.1</td>
<td>23.6</td>
<td>28.0</td>
</tr>
<tr>
<td>Japanese Equity</td>
<td>36.5</td>
<td>25.0</td>
<td>18.5</td>
</tr>
<tr>
<td>Foreign Bond</td>
<td>7.4</td>
<td>11.5</td>
<td>12.7</td>
</tr>
<tr>
<td>Foreign Equity</td>
<td>18.0</td>
<td>18.3</td>
<td>15.4</td>
</tr>
<tr>
<td>Others</td>
<td>12.5</td>
<td>17.3</td>
<td>21.2</td>
</tr>
<tr>
<td>Cash</td>
<td>2.5</td>
<td>4.3</td>
<td>4.1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100</strong></td>
<td><strong>100</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Data: PFA 2010, PFA 2000
2000 data include all types of corporate pension funds
* New Type: newly created corporate pension funds that returned government in-sourced portion.

Risk Management of Japanese Corporate Pension Funds

Low-risk management policy is also found in the Japanese corporate pension fund sector. After the painful experience of making huge additional pension-fund contributions, corporate pension sponsors in Japan have chosen a risk-averse strategy in order to avoid another financial disaster.

The recent change of pension investments by Japanese corporate pension funds is summarized below.

First, reflecting the change of the actuarial structure assumptions, the expected rate of investment return was reduced from 5 percent to 2 percent–4 percent. Table 1 shows that as of the end of March 2010, 80 percent of corporate pension funds in Japan assumed an expected rate of return of between 2 percent and 4 percent.

Compare this to the United States, where the expected rate of return centers on 7 percent–8 percent. Japanese funds need much lower investment results than their U.S. peers because they generally use a quite conservative approach to forecast the amount of future pension assets.30
Second, based on the above lower levels of expected returns, average allocations to equity in the policy asset mix (of new-type funds) have been reduced to 34 percent (see table 2).

Based on all these factors, the low-risk model is the inevitable conclusion for Japanese corporate pension funds and their sponsors. This approach reflects the Japanese attitude that the top priority of pension investment is a realistic investment policy that will pay for benefits over the long term and is based on risk tolerance—not to achieve a return that is as high as possible (Ellis 2010).11

Are Pension Funds Really Long-Term Investors?
The idea that pension funds invest for the long term leads them to take a higher level of risk. Time horizon plays the significant role when pension funds consider the appropriate level of risk. Over the past decades, everybody has believed that pension funds are long-term investors. Pension funds’ time horizons are assumed to be very long, and the longer an investment’s time horizon, the higher the risk that can be taken. That is why the conventional equity ratio of pension funds in the United States and the United Kingdom is around 60 percent.

But the time horizon for pension funds is not as long as people wish it were. In fact, given the global trend of consolidation of corporate pension funds with their sponsoring companies, and given the enhancement of accounting and actuarial rules and regulations, the practical time horizon of corporate pension fund investment could be the same as the sponsor’s time horizon, which is one year. The amount of annual pension fund losses easily could exceed the acceptable level of loss of their sponsoring companies in one year. However, current risk management theory does not usually take into account the sponsor’s loss limitations. Pension trustees tend to focus only on the pension funds’ optimum risk level and to overlook the sponsors’ financial capability.

This is the exact reason why some pension funds in some developed countries have produced unacceptable short-term losses to the companies, and it is why many U.S. and U.K. companies have retreated from defined benefit pension plans.

Public pension funds also are affected by this limitation regarding risk. So long as public funds ultimately are governed by the government, which is controlled by representatives of the general public, risk tolerance is subject to the general public’s risk tolerance, and the general public’s risk tolerance is not necessarily high. If and when the stock market collapses and performance goes negative for some time, people, the media, and politicians will complain loudly. Therefore the appropriate risk level for public funds is the amount of risk that will be tolerated by the general public.

Implication of Low-Risk Model in Japan
The low-risk model is considered an appropriate measure to accomplish pension investment objectives in Japan, which is to secure benefit payments for the long term under current actuarial assumptions. Practically, this minimal-risk strategy turned out to be rather successful over the past few decades, due to the low rate of return of the Japanese equity market throughout that period.

Low-risk investment policy may not be ideal, but it is a meaningful option, especially when people seek the long-term sustainability of a pension system in the real world.

Suggestions from Japanese Experiences
Some interesting suggestions can be derived from the case studies discussed above.

In this section, four issues are discussed as key factors for a sustainable pension system.

Constructive Interpretation of Fiduciary Duty
First, as discussed above, sustainable pension funds need flexibility on the benefit side, which means it is necessary to reconsider the concepts of fiduciary duty in a more practical, constructive way that departs from the strict interpretation of the spirit of the U.S. Employee Retirement Income Security Act (ERISA).12

Fiduciary duty in the sense of acting solely in the interest of plan members is sometimes too much of a burden for corporate sponsors in an economic downturn. Rules and regulations that strictly adhere to this interpretation and force employers to contribute to cover underfunding might result in the closure of a defined benefit pension plan; this has happened in the United States and in the United Kingdom. Such closure clearly is against the interest of the plan members.

Respect the Role of the Plan Sponsors
As emphasized in Ambachtsheer (2007a), the major agenda for any pension plan is to seek the “[a]ppropriate allocation of risks among stakeholders.” Needless to say, key players among them should be the sponsors and plan participants (employees/pensioners).

The issue here is that plan participants should be the beneficiaries of the plan, not the owners of the plan. They risk a decrease or loss of benefits, but a sponsor’s risk is unexpected additional contributions. Sponsors have the right to terminate the plan one way or the other, and it is essential not to force the sponsors to do so.

In other words, sustainability should be the number-one priority for employees and pensioners.

The only realistic pension reforms are the ones that have the consent of sponsors. A practical solution for pension problems is found by establishment of an appropriate governance structure for the system that provides for continued payment of future benefits. This is different from a solution that keeps a promise.

The Need to Reconsider the Pension Promise
A defined benefit plan has a quite ambiguous aspect because it requires plan sponsors and plan members to contribute today, with the promise as of today to pay the pre-defined benefit in
the future, many years down the road. This begs the question: Who exactly is responsible for the future payment of benefits? Those who make the promise today may not be the people to actually deliver on the promise in future decades.

It is much easier to make a promise, however difficult it may be, that somebody else is supposed to carry out. Here, the future generation is not in a position to sign the contract at all. Given the extremely political character of pension systems in many democratic countries, the burden tends to be on the shoulders of future generations who are politically weak at present.

This is the critical agency problem. In fact, those who make pension promises today do not even have the authority to represent the interests of future generations. It should not be the real "promise."

Future payment of benefits depends on the willingness and the financial capability of the sponsors, irrespective of changes to key actuarial parameters. Given the negative demographic trends in many developed countries, it would be unrealistic to assume that future generations will be able to deliver all the pre-promised liability. The reality is that future payment of pension benefits cannot be as firmly guaranteed as people today would like them to be.

Therefore, in order for the pension system to be sustainable for the long-term, the "pension promise" should be reconsidered and modified when substantial changes take place that depart from original assumptions.

Effective Management of the General Public’s Expectation about Pension Funds

For society to effectively reconsider the pension promise, it is necessary to revisit the pension system’s objectives and to understand the practical framework of supporting the elderly.

In response to the strong and sometimes unrealistic pressure of the general public, government and politicians generally tend to provide a rosy vision of pension funds.

However, everybody should recognize that flexibility, including occasional reduction of benefits when necessary, could be the only solution to keeping the system sustainable and avoiding the plan’s termination.

If we look back at history, the concept of a happy retirement with a sufficient pension for ordinary citizens is rather new.

It only started in the United States in the 1960s, when historically exceptional factors contributed: strong post-war economic growth, positive demographic trends including a burgeoning younger generation, powerful unions, and social-democratic political leadership in major western countries. These were extremely unusual positive factors that supported the growth of the defined benefit pension system. Without such exceptional supporting factors, it’s difficult for the general public to enjoy after-retirement life with sufficient pensions.

Conclusion

It is important to be realistic when we discuss pension system reform for sustainability.

A defined benefit plan should be reconsidered in a way that embraces flexibility and reduces benefits when necessary so sponsors don't lose the enthusiasm and financial capability to continue paying benefits long-term. People need to accept that a pension may not be enough to cover the cost of living in retirement. Pension systems are helpful but may not be as helpful as people wish them to be.

Key lessons from Japan’s pension system experience include the following:

- Consider a new interpretation of fiduciary duty.
- Pay more respect to plan sponsors.
- Reconsider implications of the pension promise, including the reduction of benefits.
- Manage people’s expectations about pension funds.

The bottom line is that the “sustainability” of the pension system within currently prevailing concepts and expectations will be quite difficult. But it should be possible to sustain the pension system if we can successfully modify the concept of the pension promise and effectively manage the general public’s expectations.

Sustainability of a pension system also requires reconsidering risk management of the pension investments; taking less risk makes it easier to avoid the worst-case scenario of fund closure.

Yuji Kage is former managing director and chief investment officer of Pension Fund Association (Japan). His current role includes serving as an advisor to Blackstone Group, Japan, and a number of pension funds and endowments. Views in this article are solely the author’s personal opinion and do not represent those of organizations he is affiliated with at present or in the past. Contact him at eugene_kage@yahoo.co.jp.

Endnotes

1. Some foreign investors criticized the extra contributions, complaining that Japanese corporations were paying more to retired employees than to shareholders.

2. Japanese corporate pension funds originally were based on a public pension and an additional portion based on contributions from the company and the employee. The public portion is called the “Daiko portion.”

3. Even today, Japanese corporate management generally has a strong commitment to keep workers on the job and lay them off only in extreme circumstances. However, management and unions are relatively flexible on the topic of remuneration.

4. There is some argument that this forecast is based on quite optimistic assumptions for the future, but anyway this shows some stability of the system whether it continues for 100 years or fifty years.

5. Ambachtsheer (2007b) also pointed out that in order for GPIF to develop the “high–performance” culture, Japanese society would have to address the following issues:

- national risk tolerance
- the challenge of creating an effective pension governance structure, including an effective process for selecting its board members
- sufficient level of national trust and confidence to make such a change
6 Some countries such as Canada and Sweden have been successful at creating governing boards that are less-subject to political pressure.

7 In 2011, however, a one-third reduction was planned due to the demands for recovery funds for the area of northeast Japan that was ravaged by the 2011 Tohoku earthquake.

8 There is another proposal to divide GPIF’s total assets into four or five plans for this purpose. However, it may not make sense because each plan still will be large and will head for the same markets with the same implications for liquidity. So, the idea of using only a small portion (say, 30 percent) of GPIF for investment in marketable securities could be more practical. Approximately 70 percent of the funds might be invested in nonmarketable government securities, such as in the United States. Such a change could have a meaningful impact on the return of a $1.4-trillion total portfolio.

9 Compounded total annual return of Japanese equity over the past ten years ending March 2009 was –7.69 percent; compounded annual return of international equity was –3.48 percent (PFA 2008).

10 It still would be tough to accomplish this lower return objective.

11 In order to accomplish this change of actuarial assumption, corporate sponsors had to contribute huge amounts of money for the employees and retirees. It should be quite a difficult decision for the chief executive officers of sponsoring companies to proceed toward this quite costly change. From an employee and social security perspective, this decision was impressive. On the other hand, this additional contribution could have been paid out to their shareholders (and possibly to the management). Some foreign investors criticized such Japanese companies for favoring retired employees over the shareholders. So, there are always the both sides of the coin.

12 Ambachtsheer (2007b) noted that unresolved questions remain about the most appropriate interpretation of fiduciary duty.

References


