Key theme

Corporate(private)post employment benefits

Title

A study of retirement benefit reductions

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Abstract

Since the bursting of Japan’s bubble economy the stock market has been mired in long-term stagnation, with the investment environment in recent years deteriorated to the point of negative investment yields. This has caused funding shortfalls at corporate pension plans, and many plan sponsors have been lowering retirement benefits. Subject to the consent of plan participants and beneficiaries, the law permits retirement benefit reductions in circumstances of, *inter alia*, “materially deteriorated financial performance.”

As a matter of fact, retirement benefit reductions have been the subject of several lawsuits. One example is a motion by NTT to obtain a court ruling to the effect that the Ministry of Health, Labor and Welfare acted unlawfully in its earlier refusal to approve retirement benefit reductions that NTT had attempted to implement with regard to its plan beneficiaries. In this case, the court denied the request of NTT. In its ruling, the court judged that because NTT was continuing to post profits, it was not in circumstances of, *inter alia*, “materially deteriorated financial performance.” However, since NTT and the plan beneficiaries who consented to let NTT implement the retirement benefit reductions did apply for the reductions with the Ministry of Health, Labor and Welfare, it would appear that their judgment that NTT was in circumstances of, *inter alia*, “materially deteriorated financial performance” relied on an entirely different set of criteria. Since the law provides no quantitative indicators of what constitutes circumstances of, *inter alia*, “materially deteriorated financial performance,” judgment criteria abound.

Corporate pension schemes involve a variety of stakeholders, including the management, employees, and plan beneficiaries, as well as the supervisory authority, shareholders, and pension actuaries, whose respective judgment criteria conceivably differ.

This paper discusses the judgment criteria for circumstances of, *inter alia*, “materially deteriorated financial performance” from various viewpoints in the light of the reasons why the implementation of retirement benefit reductions is permitted under the law, and in the process re-affirms the principles of protection of right to benefits and proposes measures to enable the survival of the defined benefit pension system.

In recent years, many corporate pension plans have reduced pension benefits. The reason is the protracted stock market decline after the collapse of Japan's bubble economy, with the investment environment worsened to the point of negative investment returns. As a result, many corporate pension plans became underfunded.

Moreover, in anticipation of the abolishment of the qualified pension scheme system at the end of March 2012, the transition of existing qualified pension schemes to defined benefit corporate pension plans has been gathering pace.

Retirement benefit reductions are not problematic so long as they are truly unavoidable for the continuation of corporate pension plans. Otherwise, however, reductions pose a significant issue from the perspective of beneficiary protection. This paper examines from the viewpoint of beneficiary protection the question of what makes a reduction truly unavoidable and considers desirable criteria and procedures.

Chart: Yearly chart of the number of corporate pension plans that have implemented benefit reductions

（unit：number）

	Number of the retirement benefit reductions in Employees' Pension Funds	
		with beneficiary
1997 F.Y.	7	0
1998 F.Y.	16	1
1999 F.Y.	52	1
2000 F.Y.	177	3
2001 F.Y.	131	2
2002 F.Y.	99	3
2003 F.Y.	219	15
2004 F.Y.	158	19
2005 F.Y.	111	17
Grand Total	857	61

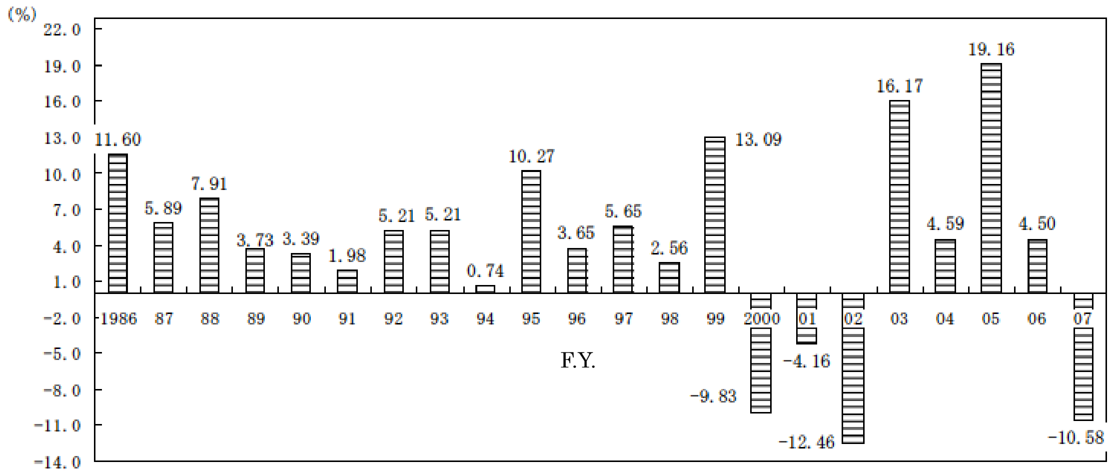
（References：Research by the Ministry of Health, Labor and Welfare）

1. Causes of underfunded pension plans

In the introduction it was mentioned that retirement benefit reductions are caused by a shortfall in pension plan assets. In the following, as a first step, the reasons for underfunding will be examined. With the stock market in long-term decline after the disintegration of Japan's bubble economy and a deteriorated investment environment to the point of negative investment returns, many corporate pension plans suffered a shortfall in plan assets. With the interest risk that attaches to corporate pension plans coming to the fore, it is easily imaginable that plan assets fell short of projections. Interest risk means the risk of underfunding as measured by the margin by which assumed pensions plan assets based on the expected yield pursuant to plan management assumptions fall short of actual pension plan assets. Figure 1 shows that in recent years instances of actual average investment yields on corporate pension plan assets falling below the average expected investment yields have become widespread.

Figure 1

Table 1　Changes in Adjusted net yield



(References：Research by Pension Fund Association)

Table 2　Assumed interest rate in supplementary pension of Employees' Pension Fund

(unit：number)

	2005 F.Y.	2006 F.Y.	2007 F.Y.	2008 F.Y.
～１．５％	1	0	0	0
１．５％～２．０％	4	2	2	2
２．０％～２．５％	10	12	10	10
２．５％～３．０％	19	21	23	22
３．０％～３．５％	29	33	34	36
３．５％～４．０％	58	58	55	62
４．０％～４．５％	40	30	35	35
４．５％～５．０％	42	43	47	46
５．０％～５．５％	6	7	7	8
５．５％	420	370	336	316
Average	4.86%	4.81%	4.77%	4.72%

(References：Research by Pension Fund Association)

Table 3　Assumed interest rate in supplementary pension of Defined-Benefits Corporasion Pension

(unit：number)

	2005 F.Y.	2006 F.Y.	2007 F.Y.	2008 F.Y.
～１．５％	2	9	18	35
１．５％～２．０％	9	33	33	58
２．０％～２．５％	35	82	125	310
２．５％～３．０％	110	216	253	433
３．０％～３．５％	112	167	199	293
３．５％～４．０％	83	121	122	153
４．０％～４．５％	72	76	72	71
４．５％～５．０％	41	43	42	37
５．０％～５．５％	1	4	4	2
５．５％	87	67	56	68
Average	3.53%	member：3.36% non-member：2.64%	member：3.30% non-member：2.55%	member：3.22% non-member：2.54%

(References：Research by Pension Fund Association)

In addition to interest risk, underfunding of pension plans results from materializing "longevity risk," "withdrawal risk," and "pay-raise risk."

"Longevity risk" means the risk of underfunding as measured by the margin by which the number of survivors based on expected mortality rates pursuant to plan management assumptions are exceeded by the number of actual survivors and the increase in pension funding needs this compels. Figure 2 shows that despite revisions of mortality rates pursuant to plan management assumptions every 5-6 years to account for increasing longevity, none of the adjustments raises the value of life annuities by more than a few percent. Consequently, given that mortality rates are relatively stable, the effect of the “longevity risk” on pension plan underfunding is small.

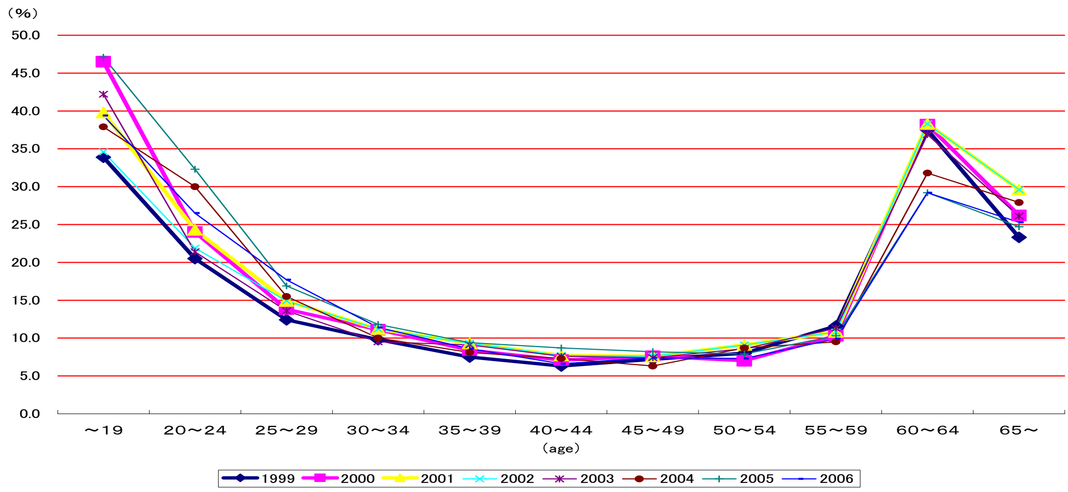
Figure 2　Present value of whole life annuity

	The 16th life table based	The 17th life table based	The 18th life table based	The 19th life table based
Present value	11.6111	11.8927	12.0844	12.5294
Increases Ratio	3.5%	2.4%	1.6%	3.7%

(Sex：Male, Pension age：60, Assumed interest rate：5.5%)

“Withdrawal risk” means the risk of underfunding as measured by the margin by which the number of withdrawals based on the expected withdrawal rate pursuant to pension plan management assumptions is exceeded by the number of actual withdrawals and the increase in funds required for lump sum benefits, and the increase in necessary fund for annuity benefits if the number of actual withdrawals is lower than expected. Figure 3 shows that turnover rates, even if viewed by age, over the last few years have been relatively stable. Although turnover rates may vary considerably for individual companies depending on the industry, on the whole the impact of “withdrawal risk” as a cause of underfunding appears to be small.

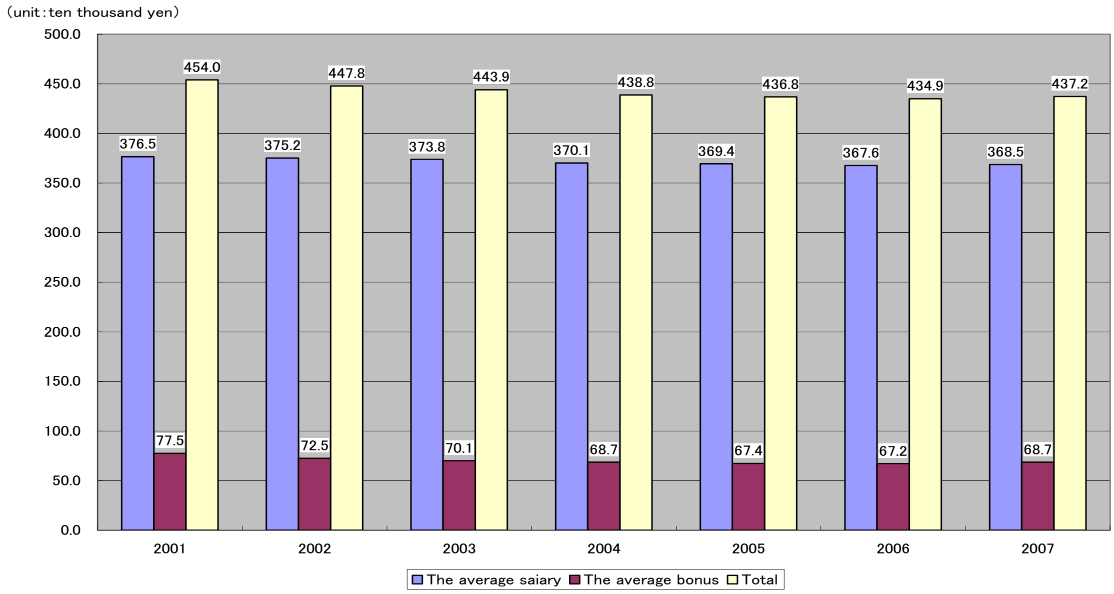
Figure 3　The quitting rate according to age class



(References：Research by the Ministry of Health, Labor and Welfare)

“Pay raise risk” means the risk of underfunding as measured by the margin by which labor compensation based on the expected growth rate pursuant to plan management assumptions is exceeded by actual labor compensation and the increase in pension funding this compels. Figure 4 shows that the stagnant economy in recent years has retarded pay raises. It is unlikely that actual compensation significantly exceeds the labor compensation based on the expected growth rates pursuant to plan management assumptions. The effect from “pay raise risk” as a cause of underfunding therefore appears to be small.

Figure 4　Progress of the average salary and the average bonus



(References：Research by the National Tax Agency)

2. Factors promoting interest risk

The previous chapter showed how the materializing interest risk associated with corporate pension plans has resulted in underfunding and prompted retirement benefit reductions. But what caused this interest risk to materialize? Obviously, with stock markets depressed and investment environments deteriorated, investment yields on pension plan assets are under pressure. But this is not all. Historically, the average expected investment yield for corporate pension plans has been over 4.5 percent. This yield looks excessive considering that the average yield on Japanese government bonds is around 1.5 percent～2.0 percent. Another fact is that under the Employee Pension Funds expected yields for all pension plans were from the outset for many years uniformly set at 5.5 percent. To date, many pension plans continue to apply this rate. However, an expected yield of 5.5 percent in current times is excessive and unthinkable. Another factor may be the changed global conditions, which have shifted to an extent unimaginable when the expected yield of 5.5 percent was established.

Progress of Government Bonds yield

(unit：%)

	2003 F.Y.	2004 F.Y.	2005 F.Y.	2006 F.Y.	2007 F.Y.
Term:10years	0.988	1.498	1.361	1.751	1.697
Term:20years	1.526	2.096	2.018	2.162	2.145

(References：Research by the Ministry of Finance Japan)

3. Current criteria for corporate pension benefit reductions

The following section examines the criteria for corporate pension benefit reductions with respect to qualified pension plans and defined-benefit pension plans (Employee Pension Funds are not considered because criteria are almost the same as for defined-benefit pension plans).

Criteria for benefit reductions of qualified pension plans

(A) Reasons･･･Either of the following reasons are necessary

(i) Reduction due to payment of corresponding benefit amounts from defined-benefit pension plans and Employee Pension Funds.

(ii) Reduction of total pension awards without reduction of annuity values.

(iii) Reduction affecting only future plan participants, with transitional measures established for current plan participants at the time of the reduction.

(iv) Reduction due to partial transfer of benefits to defined contribution pension plans.

(v) Reduction of return for enhanced employment terms including salary levels or raised retirement age.

(vi) Reduction due to financial difficulties of the corporate plan sponsor.

a) Resolution for initiation of proceedings under the Corporate Rehabilitation Law or similar reasons.

b) Negative net assets of the plan sponsor

c) As part of restructuring proceedings of a distressed plan sponsor when a pension benefit reduction is precondition to recovery.

(vii) Reduction if the plan sponsor is unable to pay its pension plan contributions due to an increase in past service liabilities caused by a significant drop in the investment yield or similar reason.

(viii) Reduction of case of a merger or business divestiture of the plan sponsor to adjust the pension benefit level to that of the merging or acquiring entity without breaching that level.

(ix) Reduction due to other reasons unavoidable and appropriate.

(B) Consent･･･Each following consent is necessary

(1) Consent of at least two-thirds of plan participants.

(ii) Consent of the labor union if at least one-third of plan participants are unionized (Consent pursuant to (1) is unnecessary when at least two-thirds of plan participants are unionized).

(The consent of plan participants or the labor union is not required in instances listed in (A) (i), (ii), (iii) and (vi)a.)

Criteria for benefit reductions of defined-benefit pension plans

(C) Reasons

(i) If pension benefits are reviewed in connection with an amendment to a labor agreement at a plan-sponsor operating site.

(ii) If a reduction is unavoidable due to financial difficulties at a plan-sponsor operating site.

(iii) If plan-sponsor contributions are set to rise significantly, with prospects of non-payment by the plan sponsor unless a reduction is implemented.

(iv) If a reduction is unavoidable in a situation where multiple pension schemes are integrated and where the pension plan sponsor becomes the successor to rights and obligations under a pension scheme.

(v) If a reduction of the plan-sponsor contribution is allocated to a plan-sponsor contribution of a defined contribution pension plan or if pension plan assets are transferred to a defined contribution pension plan.

(D) Consent

(i) Consent of at least two-thirds of plan participants (if the reduction affects not all plan participants, the consent of those affected.)

(ii) Consent of the labor union if at least one-third of plan participants are unionized (Consent pursuant to (1) is unnecessary when at least two-thirds of plan participants are unionized).

(iii) In the case of a reduction affecting qualified beneficiaries, at least two-thirds of the qualified beneficiaries (if the reduction affects not all qualified beneficiaries, the consent of those affected). Upon request of the qualified beneficiaries, an amount equivalent to the minimum reserve level as of the time of the retirement benefit reduction is eligible for payout in a lump sum.

As shown above, current criteria for reductions should meet the requirements regarding cause{(A),(C)} and procedure{(B),(D)}.

(1) Causal requirements

For benefit reductions of qualified pension plans, the criteria for the eligible reasons are divided into changes in plan regulations, e.g., as noted in Item (A)(i), and plan-sponsor circumstances, e.g., as described in Item (vi). As for reasons due to changes in plan regulations, these are specific and easy to judge, but eligible cases tend to be limited. Conversely, for reasons due to the circumstances of the plan sponsor, certain specific instances are clearly defined and easy to judge, but the rest are not and designated unavailable without a material deterioration in the financial performance of the plan sponsor.

Compared with the criteria for qualified pension plans, for defined benefit pension plans the stipulations regarding the reasons for a reduction refer not to the content of changes in plan regulations. For defined benefit pension plans, too, reasons are divided into changes in plan regulations and circumstances of the plan sponsor. For example, in the cases referred to in Item (C)(i), reductions are made contingent on changes in the labor contract, i.e., set into a wider context. With regard to reasons due to the plan sponsor’s circumstances, there is a certain amount of leeway as seen in (C)(ii). Unlike in the case of qualified pension plans where judgment is clear-cut, a reduction is not ruled out in distinct terms but the criteria as to when a reduction is possible remain vague.

In this way, compared with qualified pension plans, the criteria for defined-benefit pension plans allow for a certain range. This increases the potential reasons available for a benefit reduction, but it also creates uncertainty as to when a reduction is permitted.

(2) Procedural requirements

Consent procedures are almost the same for qualified pension plans and defined-benefit pension plans. However, a major difference in the case of qualified pension plans is the absence of stipulations for the consent of qualified beneficiaries (Conceivably, for reductions affecting qualified beneficiaries, individual permission from regulators will have to be sought.)

For defined benefit pension plans, compared with reductions affecting plan participants, the requirements for reductions affecting qualified beneficiaries are restricted and the handling is different.

4. Benefit reduction due to materially deteriorated financial performance

The following section considers recent examples of litigation over pension benefit reductions

(1) Recent law suit over reduction of pension benefits of beneficiaries

(i) Reduction of benefits of beneficiaries of a contract-type defined-benefit pension plan at NTT Group

In 2005, NTT Group sought a contractual amendment stipulating a cash-balance type arrangement for the pension benefits of qualified beneficiaries under a contract-type defined benefit pension plan. NTT Group had obtained the consent of at least two-thirds of qualified beneficiaries and applied for approval with the Ministry of Health, Labor, and Welfare. This approval was denied on grounds that in the judgment of the Ministry neither of the requirements for approval of a benefit reduction for qualified beneficiaries applied to NTT Group, namely, pursuant to the Enforcement Regulations for the Law Concerning Defined-Benefit Corporate Pension Plans, Article 5, Clause 2, that "deteriorated financial performance at the plan-sponsoring operating site renders a reduction of benefits unavoidable" and pursuant to Article 5, Clause 3, that "without a benefit reduction, plan sponsor contributions will substantially increase, with prospects that sponsor-contributions cannot be paid by the plan sponsor, making a benefit reduction unavoidable." (in the following "reasons for a reduction")

In response, NTT Group sued to have the ruling against its application for a change of its contract annulled. NTT Group asserted that it had posted a profit for the period only due to the accelerated lump-sum recognition of retirement expenses related to personnel cuts as extraordinary losses, and that its financial performance was not improving but on a falling trend.

This claim of NTT Group was turned down. According to the court, irrespective of what factors were responsible for the improvement in earnings, NTT Group did at the time of the ruling post a significant profit, which in the judgment of the court made it evident that neither of the reasons for a pension benefit reduction applied.

	Content of the reduction of benefits of NTT Group pension beneficiaries
Before the reduction	Pension annuity rates of annually 7.0% or 4.5%, and interest until the annuity start date of annually 5.5% or 3.0%.
After the reduction	Cash balance plan with adjustable pension annuity rate and interest until the annuity start date calculated on the basis of the 10-year JGB coupon rate. The floor of the adjustable rate is set at the minimum expected yield or 1.5% per annum, whichever is higher. The ceiling of the adjustable rate is set at 7.0%. Beginning with the month of implementation, a transitional measure is available such that the floor for the pension annuity rate is set at 3.5% for the duration of six years.

(ii) Reduction of benefits of beneficiaries of the Resona Employee Pension Fund

In 2004, the Resona Employee Pension Fund reduced its pension benefits, lowering the pension benefit level of pension plan beneficiaries by an average 13 percent. The circumstances of the parent plan sponsor were such that in 2003 it had received public funds from the Deposit Insurance Corporation of Japan, additionally cut pension benefits for currently serving employees by an average 20 percent, and implemented drastic personnel cuts. At least 80 percent of the beneficiaries of the Resona Employee Pension Fund consented to the reduction, which was approved by the Ministry of Health, Labor, and Welfare.

Among the beneficiaries who had not consented, a number brought legal action to claim the reduction amount. They asserted that since the investment environment had started to improve and the shortfall in pension assets in the fiscal year to March 2005 had disappeared, Provision 3-7-(5) of the Criteria for Permission to Establish an Employee Pension Fund which establishes the condition of ”if a reduction is truly unavoidable for the further continuance of the pension fund“ did not apply.

This claim was turned down. Taking everything into account, i.e., that the plan-originating plan sponsor had received public funds from the Deposit Insurance Corporation of Japan and that financial performance had materially deteriorated, as well as the magnitude of the reduction of pension benefits of the affected beneficiaries and the fact that at a minimum of 80 percent of all beneficiaries a significantly large number had approved the content of the reduction, the court found the plaintiff’s assertion that Provision 3-7-(5) of the Criteria for Permission to Establish an Employee Pension Fund which establishes the condition of ”if a reduction is truly unavoidable for the further continuance of the pension fund“ did not apply was untenable.

	Content of the reduction of pension benefits of beneficiaries of the Resona Employee Pension Fund.
Before the reduction	Pension annuity rates between 5.5% and 8.0% annually (This fund is the result of a merger of multiple Employee Pension Funds due to the restructuring of parent entity operations. Owing to differences in the participating Employee Pension Funds before the merger, pension annuity rates varied in the range between 5.5% and 8.0%.)
After the reduction	With regard to one-half of the annuity principal : Pension with a 4.5% annual pension annuity rate. With regard to the second one-half of annuity principal: Cash balance-type pension plan with adjustable pension annuity rates between 2.5% and 5.5% based on market interest. (The initial pension annuity rate is 3.5% annually.)

(2) Requirements regarding “material deterioration in financial performance” as a reason for a reduction

The Ministry of Health, Labor, and Welfare denied to approve a reduction of pension benefits of beneficiaries of NTT Group on the grounds that a “material deterioration in financial performance” was not present. However, at least two-thirds of qualified beneficiaries had consented to the reduction that NTT Group sought to implement. Therefore, while in the judgment of the Ministry of Health, Labor, and Welfare this reduction was not one due to a “material deterioration in financial performance,” the qualified beneficiaries had consented to the reduction for just that reason.

The reduction that NTT Group sought to implement was slated to be followed initially by a guaranteed annual 3.5% pension annuity rate. Based on this information, the fact that at least two-thirds of qualified beneficiaries consented would suggest that relative to the plan sponsor’s earnings situation and compared with the market environment, the pension annuity rate was too rich and a reduction at the level proposed by NTT Group unavoidable in the view of the qualified beneficiaries. In other words, for the qualified beneficiaries their criteria for consenting to a reduction was the question as to “how much of a reduction” (quality and extent) more than the reason.

In the case of the Resona Employee Pension Fund, too, at a minimum of 80 percent of all beneficiaries, a large number had consented. Even though the injection of public funds received by the plan sponsor constituted a special factor and evidently an eligible reason for a benefit reduction, taking into account that an annual 3.5% pension annuity rate was to be guaranteed initially after the reduction, this underscores the impression that beneficiaries' criteria for consent was the question of "how much of a reduction" (quality and extent).

In other words, conceivably there may have been an unwillingness to consent to a large reduction, irrespective of a material deterioration in the financial performance, but also there may have been a preparedness to consent to a small reduction even if the deterioration in financial performance was slight. Thus, depending on the content of the reduction (quality and extent), different reasons for a reduction should be eligible. This would suggest a need to review the statutory requirements applicable to reasons for reducing pension benefits, bearing in mind the content of the reduction (quality and extent).

(3) Judgment criteria for "material deterioration in financial performance"

The Ministry of Health, Labor, and Welfare judged that the reason for a reduction of pension benefits was not applicable to NTT Group because NTT Group was not in a situation of a "material deterioration in financial performance" and therefore turned down the reduction of pension benefits of beneficiaries that NTT Group was seeking to implement. The criteria for this judgment, however, are nowhere made explicit.

The ruling holds that "whatever the reason for the improvement in earnings, if a significant profit is posted, this is not consistent with a material deterioration in the financial performance." However, assuming NTT Group too had posted a loss from temporary extraordinary losses, would this have resulted in a ruling that a material deterioration in the financial performance was present? Furthermore, in the case of the Resona Employee Pension Fund, after the plan sponsor had received public funds, if subsequently even a small profit had been posted, would this have resulted in a ruling that a material deterioration in the financial performance was not present?

From the beginning, it would appear that the beneficiaries who consented to a reduction of pension benefits – since they did consent to the reduction – used criteria in their judgment entirely detached from whether a material deterioration in the financial performance was present. For example, plan beneficiaries may have judged that in the constantly evolving information and communications industry, failure to allocate today's profit to R&D expenses will before long lead to a loss of competitive strength and may affect the existence of the enterprise, perhaps thinking that withholding their approval of the reduction may cause the demise of the enterprise itself a few years hence.

In the following it pursues the subject around defined benefit pension plans

5. Requirements to be met by reasons for a pension benefit reduction

(1) Is there a need for such requirements?

To begin with, is it necessary that reasons for a pension benefit reduction meet certain requirements? While few will dismiss out of hand the need for requirements, opinions will be divided on whether requirements should attach to reasons behind all benefit reduction. Obviously, reductions are implemented because there are reasons to do so. The question is, whether a single reason suffices for an explanation.

Statutes require that there be a reason for the implementation of a pension benefit reduction, but there are no defined conditions regulating the extent and content of reductions, nor criteria as to how far a reduction may go for any given reason, which introduces variation regarding the content of a reduction (quality and width). In the practice of pension benefit reductions, there are instances where the content is a combination of several changes. Instances of this kind, too, are at times explained by a single reason. Plan participants, however, consent not to this single reason but to each individual aspect of a reduction, making it hard to assert a strong correlation between the total content of a reduction and a single reason. Thus, it would appear that instances of pension benefit reductions can be divided into those that are interrelated with the specific reason for the reduction and those that are not.

For example, in the case of a pension reduction by one-third of the annuity amount, the reason will likely be "a material deterioration in financial performance." However, the reason judged to be a reduction as a result of probability calculation like the revision of the level of the salary etc, there will also be aspects that are not closely related to the reason. If such a benefit reduction is by force associated with a reason and conditions it must satisfy and on that basis is explained to employees, it could conversely invite misperception. In this kind of case, it would seem commendable not to attach a reason and conditions to be met and exempt the case from the application of statutory requirements regarding the reason for the reduction, but still require that employees' consent be obtained based on an appropriate and fair explanation. With regard to the requirements for reasons under existing statutes to implement a reduction, it would appear necessary to exempt benefit reductions of certain descriptions from the application of reason requirements and also take steps to reinforce procedural aspects.

(2) How is a reason requirement going?

Leaving aside benefit reductions where reason requirements are not necessary, the exhaustiveness of reason requirements must be verified for those reductions where reason requirements do apply. For example, according to the Enforcement Regulations for the Defined Benefit Corporate Pension Plan Act, Article 5, Clause 2, a reason for a reduction is not present unless there is a situation of a deterioration in financial performance, past or present, while the same situation in the near future does not qualify. Furthermore, Article 5, Clause 3, of the Enforcement Regulations concerns increased plan-sponsor contributions, a criteria based on future cash availability. This shows that under existing criteria the requirements for a reason for reduction are a current deterioration in financial performance and a future deterioration in cash availability. Therefore, a plan sponsor cognizant of an approaching future deterioration in financial performance will have to wait until this actually happens before a pension benefit reduction can be implemented.

This situation would suggest that the time for a necessary review has arrived from the perspective of the continuance of corporate pension plans. A realistic method would be to accumulate all descriptions of historical reduction instances to date, even though there are some that such a framework will not capture. For example, in the case of a reduction where the required reason is a "material deterioration in financial performance," the reason lies outside the pension system, while reductions whose factors reside within the pension system, for instance, a variable element may have to be considered independently. In other words, even in instances where reductions require certain reasons, it may be necessary to consider establishing separate criteria, for example, for reductions that are due to effects from a variable interest element.

(3) Who judges, and how, what reasons are required?

Whether a deterioration in financial performance will occur in the near future is not open to judgment until that time arrives, but assuming that a reduction were possible on that grounds, its could result in an unnecessary reduction. On the other hand, if a reduction is necessary but not possible, this could endanger the continuance of the entity. Ultimately, the criteria for the necessity of a benefit reduction will vary depending on who judges and how that judgment is exercised. This means, given that absolute, objective indicators are absent, the subjective views of the plan sponsor, employees, and beneficiaries, will inevitably come into play.

The ability to appropriately identify a situation of material deterioration in financial performance resides in the first place with the plan sponsor, i.e., the company management. Since employees are not part of the management, it is not for them to judge whether a deterioration in financial performance is present, but their view will depend on whether or not they trust the explanations offered them by management. Their criteria for judging a situation are formed through the internal view from within, such as based on the conditions within the company, through the work place, or earlier action taken by the company, and are not visible from the outside. In the case of a reduction affecting beneficiaries, the consent of the beneficiaries is required. Since beneficiaries are already retired and outsiders, their judgment criteria will be slightly different from those of plan participants. This means, when obtaining plan participants' and beneficiaries' consent to a reduction, there will be variance in the judgment criteria depending on the differences in their respective positions.

Corporate pension plans involve a variety of stakeholders, including, first of all, management (the plan sponsor), employees (the plan participants), and beneficiaries, as well as the regulator (the Ministry of Health, Labor, and Welfare), shareholders, and pension actuaries, each party conceivably with their own judgment criteria. Thus, managements' (plan sponsors) judgment will focus on the continued future existence of the business, employees (plan participants) will focus on their company's ability to pay employees' salaries, beneficiaries on the company's ability to pay their pensions, the regulator (the Ministry of Health, Labor and Welfare) on past performance, and shareholders on the historical dividend payment record and dividend outlook, and actuaries, too, will have their own angle. This situation calls for a review, mindful of the aspect of beneficiary protection, of the criteria for the judgment as to when a "material deterioration in financial performance" is present.

6. Criteria for judgment on a pension benefit reduction

The following tabulation shows stakeholders' interests and judgments directly and indirectly related to corporate pension plans

	Plan sponsor	Employees	Beneficiaries	Regulators	Shareholders, etc.
Party related to the pension benefit reduction	○	○	○	○	×
Non-interested party	×	○	○	×	×
Company-internal party	○	○	×	×	×
Understands company valuation	○	×	×	×	○
Understands the pension plan	○	×	×	○	×
Purpose / objective	Enhance enterprise value	Secure post retirement income	Secure post retirement income	Beneficiary protection	Obtain income
Significance of the pension plan	Cost	Labor compensation	Livelihood	—	Cost

Viewed from stakeholders' respective positions, the following picture results.

○ The plan sponsor is the entity that implements the pension benefit reduction. As management, the plan sponsor understands the situation of the company and seeks to promote the company's continuance, growth, and enterprise value. Shareholder value is a further consideration. Management correctly understands the factors behind the implementation of a pension benefit reduction, consults with the plan administrator institution (pension actuaries) when changes are made, and understands the effect. However, the order of priorities in dealing with the pension plan as a step to mitigate a deterioration in financial performance will vary, depending on the company's judgment. It is also conceivable that with a view to shareholder value a benefit reduction may be carried out to generate profits.

○ Employees are parties related to the benefit reduction. Although employed with the company, they may not necessarily have a correct understanding of the company's management situation. Moreover, many employees do not understand their corporate pension plan. With regard to their consent to a reduction, since employees judge the plan sponsor's explanation from their position and through their work place, criteria for judging the merits of a proposed reduction will vary depending on the employee. For example, together with a benefit reduction, a workplace environment enhancement (for instance, an extension of the statutory retirement age) as a measure extraneous to the corporate pension plan will figure as a prominent factor in their judgment. That is, since the pension plan is one form of labor compensation, the judgment will focus on the change in overall labor compensation. Consequently, rather than the reason for the benefit reduction, the judgment will depend on the content of the reduction of the wider picture of labor compensation. There is a possibility that the vulnerable position in labor relations it consequentially influences the acquisition situation of consent.

- ○ Beneficiaries are parties related to the reduction. Although previously employed with the company, with the change of status to beneficiaries they become company outsiders who are not informed of the conditions of the company. Since they do not belong to the organization, they are isolated. Their vertical information (information from the company) and horizontal information (information among beneficiaries) are therefore insufficient. Nor do they share the viewpoint of labor compensation held by employees. Since the corporate pension provides their livelihoods, their only judgment criteria are the reason for the reduction and the reduction content indicated by the plan sponsor.

- ○ Regulators form the institution that approves the reductions. They verify the fairness of the reasons for the reduction and the reduction procedures. However, since the appropriateness of the reduction content is not a statutory requirement, it is unclear how thorough a verification is implemented for a reduction to be approved. It is believed that regulators validate the fairness of the reasons for a reduction from an objective standpoint, but their criteria are not known. Since regulators too do not verify enterprise value, for a judgment on a deterioration in financial performance, for example, they rely for information mainly on reports from management.

- ○ Shareholders are not directly related to a benefit reduction. While shareholders may require that cost be reduced, to date, at least, there have been no specific requests such as for management to lower the projected benefit obligations of beneficiaries. In other words, shareholders go not as far as indicating what part and what constituency of a pension plan should be the subject of a reduction. If they did, presumably it would be a call to reduce projected benefit obligations overall by a specific amount.

In this way, stakeholders' perspectives on pension benefit reductions vary significantly depending on their position. A synopsis follows below.

(i) Management, which has a correct understanding of the company's situation, should inform those affected by the reduction (employees and beneficiaries) and regulators accurately and in good faith of the reason for the reduction and the reduction content. Depending on the case, a third institution may be needed to verify that information (for example, an audit firm for verifying the appropriateness of the reason for reduction, and an actuary for verifying the accuracy and effect of the reduction content).

(ii) In order to prevent that profits that result from the reduction are allocated to shareholder dividends, the allocation of such profits should be restricted. Alternatively, a verification scheme would appear necessary.

(iii) Since the significance of a pension plan differs significantly from the perspective of employees and beneficiaries, respectively, reason requirements and procedure requirements should be categorized. For example, the correlation between reduction content and the reason for a reduction is thought to be stronger in the case of beneficiaries compared with employees. On the other hand, in the case of employees, labor compensation may for some reason be amended and as part of that amendment a reduction of pension benefits may be implemented. Since it is imaginable that the reason for a reduction has no practical significance, a method needs to be devised that enables implementing a reduction if those affected by it have given their consent.

(iv) As reason for a reduction, an explicit condition needs to be created under which employees can consent to a reduction of their corporate pension plan, viewed by them as labor compensation. (Increase in statutory reasons.)

(v) Given the need on the part of beneficiaries to avoid erroneous judgment and insufficient information, arrangements are necessary that emphasize procedure requirements more than reason requirements.

(vi) Since regulators are the institution that ultimately examines the content of a reduction, objective judgment criteria will become necessary. For example, the creation of indicators is conceivable, but their preparation would require concerted discussions involving, among others, pension actuaries, accountants, and regulators.

7. Proposal for reduction criteria

Reduction criteria are discussed below. The following premises apply.

Premises

Q1. Are reasons for a benefit reduction necessary?

A. Not always. If a reason is serves the approval application instead of promoting the reduction consent, this causes needless misunderstanding on the part of plan participants and beneficiaries. Reason requirements are divided into necessary and unnecessary reason requirements.

Q2. What categories are available for classifying reason requirements as necessary and unnecessary?

A. The following perspectives are conceivable.

- Categories distinguishing reductions that are possible based on a calculation of total benefit cost from those reductions that are evidently unreasonable.
- Lump sum retirement allowances due to retirement owing to personal reasons are treated as “deferred labor compensation.” Other elements (the differential between retirement benefits due to the employer reasons / normal retirement and due to personal reasons; life element.) are categorized as “compensation for services” without being treated as deferred labor compensation.
- With respect to amounts freed by the benefit reduction, segregation into amounts that should and should not be accounted for as profits.

Q3. Are reason requirements necessary other than currently existing?

A. The following reasons are conceivable.

- Reduction related to interest risk.
- Reduction related to a future deterioration in financial performance.
- Reduction due to labor contract amendment, and others.

Q4. Is consent to the reduction necessary?

A. Necessary, as currently practiced.

Q5. What are the procedures for obtaining consent?

A. The following perspectives are conceivable.

- Categories of procedures for employees (plan participants) and beneficiaries
- Higher requirements for the explanations by the plan sponsor concerning the reason for a reduction, etc.

(Proposal for reduction criteria)

Establishment of separate categories for dealing with plan participants and qualified beneficiaries

〇Benefit reductions affecting plan participants

Separate categories should be introduced for benefit reductions that do and do not require reason requirements. A segregation into “deferred labor compensation” and “amounts other than deferred payment.” should be established. Reason requirements are necessary with respect to deferred labor compensation, but are not necessary with respect to amounts other than deferred labor compensation. Procedure requirements (explanations by the plan sponsor and obtaining consent) should continue, however. Moreover, “deferred labor compensation” is sub-divided into a historical portion and future portion.

The “historical portion” of deferred labor compensation means the amount of the lump sum retirement allowance payable in case of retirement due to personal reasons, assuming a change in regulations and assuming that retirement occurs at the time of that change. In this way, because in the case of plan participants pension payment has not started, the concept is based on lump sum retirement allowances.

(1) Deferred labor compensation (historical portion)

Performance of procedures for a reduction that as a reason requirement demands only a “(i) material deterioration in financial performance at the plan-implementing operating site.”

Example: Reduction of cumulative points under a point system and reduction of the benefit rate in case of retirement due to personal reasons.

(2) Deferred labor compensation (future portion)

In addition to the reason requirement of Item (i), performance of procedures for reduction with “(ii) reduction due to future deterioration in financial performance” and “ (iii) reduction due to change in labor terms and conditions” as reason requirements.

Example: Change in annual points under a point system and reduction of the benefit rate in case of retirement due to personal reasons (if a transitional measure is established for the historical portion).

(3) Amounts other than deferred labor compensation

Reason requirements are unnecessary but procedures for the benefit reduction should be performed. However, reason requirements are unnecessary only for the handling purposes under the regulator’s procedures. The plan sponsor should still provide an accurate explanation to its employees of the reason indicated for the change to be implemented

Example: Change in the benefit payment start age.

The part according to the amounts related to interest changes installs the standard separately.

(4) Amounts related to interest changes

In cases where a certain level of interest risk is exceeded, procedures for a reduction should be performed by providing employees with an explanation and obtain a written statement of consent. (Details are described later)

Example: Change of pension annuity rate; cash balance revaluation rate.

In any case, the plan sponsor should provide plan participants (employees) with an accurate explanation of the reason for the reduction and the reduction content, and obtain employees’ consent. Especially with regard to the reason for the reduction, since for employees the plan sponsor’s explanation is of preeminent importance, the plan sponsor should strive to preserve objectivity.

〇Reductions affecting qualified beneficiaries

Since qualified beneficiaries, unlike plan participants, are already receiving current benefits, it is necessary to segregate the handling from that for plan participants. In the case of plan participants, the lump sum benefit in case of retirement pursuant to a change in regulations have been defined to be treated as “deferred labor compensation.” However, in the case of beneficiaries, their benefits have vested and implementing a retirement benefit reduction is generally difficult. However, since it is conceivable that risks emerge over the long term during the benefit payment period, in the interest of pension benefit payment continuance, a reduction may become necessary. Conceivable as risk factors for beneficiaries are interest risk and longevity risk. For interest risk, which tends to be high, the handling is considered separately.

(1) Amounts related to interest changes

Pension annuity rate settings mean incurring permanent future market interest risk. In case of a drastic change in the environment, even if the plan sponsor until that time has in good faith managed the pension plan, the continuation of benefit payments may be imperiled by external factors. Therefore, to mitigate this risk, a reduction should be possible in the following cases without needing reason requirements. However, reason requirements would be unnecessary only for handling purposes under the regulator's procedures. The plan sponsor should still provide an accurate explanation to the beneficiaries of the reason stated for the change to be implemented.

(Case that can be reduced)

In case of predetermined conditions of interest risk manifestation

Reductions are possible provided a predetermined benefit level is not breached.

Except that such reductions must be reverted to the benefit level before the reduction when the predetermined situation of interest risk manifestation is resolved.

Example

"Predetermined situation of interest risk manifestation" means, for example, that the present 5-year average JGB yield is less than 70 percent of the 5-year average JGB yield at the time the pension annuity rate was set.

"Predetermined benefit level" means, for example, a benefit level corresponding to a pension annuity rate of 70 percent of the present pension annuity rate.

(2) Amounts other than variable interest

Amounts other than the variable interest portion correspond to the installment payment element of retirement benefits and the longevity risk in case a life annuity is paid. Since the former element is normally funded through a retirement allowance and regarding the latter the longevity risk is relatively stable, there is no heavy impact on the plan sponsor comparable to the interest risk referred to above. Consequently, reductions of this element should be limited to instances where doing so is truly unavoidable for the continuance of the pension plan. Therefore, by and large, the existing procedures as described below should be applied.

Reduction procedures should be carried based on reason requirements "Material deterioration in financial performance at the plan-implementing operating site"

Example: Reduction of the life element with a change to an annuity certain. Uniform 30% reduction of the pension amount.

In any case, the plan sponsor should provide beneficiaries with an accurate explanation of the reason for the reduction and the reduction content, and obtain beneficiaries' consent. Especially since beneficiaries are prone to have insufficient information, it is necessary to set aside plenty of time to supply information, provide a venue for open discussion, and prepare such other measures. Moreover, as with plan participants, plan sponsors should strive to preserve the objectivity of their explanations.