

*Traditional Severance Pay Plans
&
New Defined Contribution Plans
in Japan*

(Draft)

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Summary

Japan's "Defined Contribution Plan Law," enacted in June 2001 and enforced in October 2001, went into effect at the worst possible time for Japanese companies. Prevailing interest rates in Japan hover near-zero and many labor unions are still skeptical about the merits of such DC plans. Moreover, the DC Plan Law is deeply flawed. That said, 70 major companies have announced they will establish DC plans in the near future.

Why is this so, and why do employees agree with their employers?

The life-long employment system was a unique characteristic of the Japanese traditional employment relationship that dominated big-sized companies until 1980s. And the lump-sum severance pay plan was the cornerstone of the life-long employment system.

Before WW II, the number of employers who offered severance pay as a retirement bonus increased and severance pay plans were prevalent among big companies. These payments were considered to be a reward to workers for their long years of service. But during the postwar reconstruction and rapid economic growth, most major companies in Japan adopted the life-long employment system in order to recruit, educate, and retain talented workers. Employer-provided severance pay plans were established, and typically maximized the benefits at the retirement age fixed by each company's condition of employment. This characteristic of severance pay plan was mutually beneficial for both of employer and employee.

In the 1960s, most companies did not abandon their severance pay plans because lump-sum payments at retirement were very common and popular among employees. Instead, some employers offered corporate pension in addition to the severance pay plans. Others offered pension plans by converting a portion of the severance pay plans. Even in the pension plans, lump sum payments remained popular. In those days, severance payments were considered to be a mixture of reward and deferred compensation.

After the bubble economy burst in 1990, the Japanese employers reviewed and revised their compensation systems to survive the long depression and competitive markets. Over time, they came to lay weight on performance pay more than basic or seniority pay. In this context, most major Japanese firms ended their life-long employment and their seniority pay structure and introduced a new "Point System" scheme into the traditional severance pay plans or DB plans to reflect the performance of employees. Actually, this "Point System" could be described as the first phase of the introduction of new DC plans in Japan.

On April 1, 2001, a new accounting rule was introduced to help investors better understand the financial situation of the Japanese listed companies. According to *the Financial Accounting Standards for Business Enterprises in Japan*, companies are required to reflect the full scope of liabilities of their retirement benefit plans, including severance pay, and to show those total liabilities in their finance reports. But to compensate for the drop in

corporate income tax revenue, limitations on “Reserves for Retirement Allowance” of the severance pay plans were halved, from 40% to 20%, and will be dropped altogether in 2006.

There isn't much consistency among Japanese companies in establishing DC plans. Some small and medium-sized companies that do not currently offer any retirement benefit plan will introduce a DC plan partly because the initial costs of DC plan are much lower than DB plans. Some companies will abandon all their current retirement plans before setting up DC plans. But, at the first stage in Japan, most seem to favor setting up DC plans by converting current severance pay plan.

There are two key dates for DB plans: The first will be in Fall 2003, when the EPF will be allowed to convert into other DB type plan or DC plan by refunding its substitutional portion to the Government. The second is March 2012, when the TQRP will be abolished. By this date, the company that currently offers TQRP should convert it into other DB plans or a DC plan.

From the employee's point of view there are two advantages: First, the employer's contributions are accumulated in the dedicated account for a DC plan and the assets in the account are protected solely for beneficiaries. And second, accumulated assets in DC plans are portable. What this means is not only that employee can easily change the job but also that employee who changes employer can defer the taxation on severance pay until they turn 60.

In conclusion, it seems as though most Japanese companies are now responding to the inconsistencies between the new accounting rule and the Tax Code by converting their existing severance payment plans into a DC plan. But these companies will have to continue to reassess to determine what combination of DB and DC might be best for their retirement benefit plans. This transition period will likely take several years, but change is surely underway.

1 Why are the Japanese Companies Setting up the Defined Contribution (DC) Plans at the Worst Possible Time?

Japan's "Defined Contribution Plan Law," enacted in June 2001 and enforced in October 2001, went into effect at the worst possible time for Japanese companies.

Firstly, Japanese interest rates have been at their lowest levels since WW¹. The stock market index is also depressed, and stands at one-third the level achieved at the end of 1989². In addition, the Japanese banks have not yet shed their bad loans, which are dragging down all economic activities and the future of Japan.

Under these economic situations, Defined Contribution (DC) plans are not favorable for either employers or their employees because the rate of accumulation in individual accounts is low, due to near-zero interest rates. In addition, employer will have to pay heavier administration costs than they would under Defined Benefit (DB) plans. As a result, employers must contribute much more in order to provide their employees a sufficient nest egg upon retirement.

Secondly, the Japanese Trade Union Confederation (Rengo)³, the largest national center of labor unions, strongly opposes the introduction of the DC plans because most Japanese employees are inexperienced in handling their investments and the Japanese financial market has not been transparent⁴. While some labor unions have agreed to discuss the introduction of a DC plan with employers, other labor unions are still skeptical about their merits. Employers who want to set up DC plans should be prepared for tough negotiations with labor unions.

Thirdly, the DC Plan Law is deeply flawed:

- 1) The amount of contribution is too limited. The maximum contribution is 216,000 yen / year for employees with qualified DB plan, 432,000 yen / year for employees with no qualified DB plan, and 816,000 yen / year for those who are self-employed.
- 2) Contributions by employees are prohibited in corporate-type DC plans. Unlike 401(k) plans in the US, Japanese employees cannot benefit from deferrals or matching contribution by their employers.
- 3) Dependent spouses are not eligible for an Individual-type DC plan.
- 4) Participants cannot withdraw any portion from their accounts before they reach 60 years of age, unless they are disabled. (Should a participant die before 60, his/her benefits accrue

¹ Annual rate for Installment saving is 0.047% at April 1, 2002 (by Bank of Japan).

² Nikkei Stock Index was 11,024.94 at the end of March 2002. It is less than one third of 38,915.87 at the end of December 1989 (by Nihon Keizai Shimbun).

³ <http://www.jtuc-rengo.org/>

⁴ <http://www.jtuc-rengo.org/statement/2001june12.html>

to survivors.) Unlike 401(k) plans, Japanese participants cannot use the amount in their accounts for emergencies or to purchase a home.

According to the Nihon Keizai Shimbun, although the circumstances are the worst as described above, 70 major companies already declared that they will establish DC plans in the near future. Why is this so, and why do employees agree with their employers?

2 Traditional Employment Relationship

The life-long employment system was a famous/notorious characteristic of the Japanese traditional employment relationship that dominated big-sized companies until 1980s. Indeed, the Japanese severance pay plan was considered as the most important component to support the life-long employment system.

To explain the importance of the severance pay plan in Japan, it is useful to look at its origins.

- 1) In the Edo era (1603-1867), there were three big consumer markets – Edo (the ancient name of Tokyo), Osaka, and Kyoto. Many feudal lords tried to promote agriculture, handicrafts industry and merchants to trade with those markets in order to make profits for their inhabitants as well as themselves. In those days, handicraftsmen and merchants employed young people, sometimes children, who had grown up in tenant farms in rural areas.

Under those arrangements, the terms of employment were fixed in advance and at the termination of the employment, the employer provided the severance pay for employees. This severance pay was considered as the reward for his/her long years of work, not as compensation.

The amount of the severance pay was therefore discretionary. Sometimes the payment was enough for the resigning employee to begin his own business. Some employers provided their female employees everything for her wedding, just like their own daughters. And sometimes the payment was only enough to cover a few months expenses.

- 2) Throughout Meiji era and before World War , Japan experienced its own Industrial Revolution and its primary capitalism took hold. Many people moved from rural to urban areas to work in factories, shops or offices. Most of them did not have property or financial assets at retirement. Here too, many employers provided severance pay as a retirement bonus and severance pay plans became common in big companies. But these payments were still considered to be a reward for employees' long terms of service.
- 3) During the postwar reconstruction and rapid economic growth, most major companies in Japan adopted the life-long employment system in order to recruit, educate, and retain talented workers. Employer-provided severance pay plans were established, and typically maximized the benefits at the retirement age fixed by each company's condition of employment. This characteristic of severance pay plan was mutually beneficial for both of

employer and employee. Employers were enabled to retain talented and educated workforce with less cash flow. And employees had confidence that he/she would not be fired unless he/she made criminal acts and that he/she would receive sufficient lump-sum payment at retirement age that would allow the purchase of a home for retirement.

As severance pay plans grew in popularity and importance, the Japanese government took steps to ensure that employers maintained adequate reserves for severance payments. In 1952, the Tax Code was changed to create “Reserves for Retirement Allowance,” by which employer could accumulate the amount tax-free.

In the 1960s, two types of corporate pension (DB plan) were introduced. One was the “Tax Qualified Retirement Pension (TQRP)” in 1962, and the other was the “Employees’ Pension Fund (EPF)” in 1966, which contained a substitute portion of the public pension (“Employees’ Pension Insurance (EPI)”)⁵.

But most companies did not abandon their severance pay plans because lump-sum payments at retirement were very common and popular among employees. So some employers offered corporate pension in addition to the severance pay plans. Others offered pension plans by converting a portion of the severance pay plans. Even in the pension plans, lump sum payments remained popular. Indeed, 96.1% of TQRP have a provision to allow employee to choose whether to receive a lump sum.⁶ Fully 40.1% of retirees covered by EPF chose to receive their retirements in a lump sum.⁷

In short, severance payment was treated as a mixture of reward and deferred compensation. Usually, companies provided a written version or agreement about their severance pay policies. In this context, employees were vested to some extent because employee could anticipate how much they would receive as severance pay at the age of resignation or retirement. From the company’s perspective, severance pay was maximized at the retirement age, fixed in advance by the companies, because it was calculated on the basis of years of service and the salary achieved at the end of workers’ careers. And because salaries naturally grow with seniority under a life-long employment system, a high severance pay package was a reward for employees who served the employer for many years.

3 Restructuring and “Point System” in Severance Pay Plans

The Japanese economy has been stuck in a long depression since the bubble economy burst in 1990. Most Japanese companies have been trying to select their core businesses and concentrate their resources there. Some companies did so successfully, but most companies

⁵ When employer chooses to establish the EPF with the agreement of employees, the employer is required to manage the EPF including a certain portion (substitutional portion) of *Employees’ Pension Insurance* (the public pension mandatory) of its employees. What this regulation means is that the employer should be responsible for managing, investing and distributing the portion of the public pension for its employees.

⁶ Ministry of Health, Labor and Welfare, 1998

⁷ The Association of EPF, 1997

encountered too many obstacles to restructure. For example, there were no commercial laws on the books to allow companies to merge or to split or sell some divisions of the companies.

As a result, major Japanese companies shifted a portion of their employees to their subsidiaries. However, even in these cases, companies had to remain the technical employer of the shifted workers because their severance pay packages were not portable. If an employee resigned from the parent company and moved to a subsidiary, the parent company was then required to pay the severance pay to the employee. And the employee would then have to pay income taxes on the severance pay. In addition, according to the Japanese Tax Code, the longer the employee serves, especially more than 20 years, the larger the basic deduction from the severance pay income.⁸ Japanese companies were therefore unable to restructure to the full extent that they wished – it wasn't until 2001 that companies were allowed to split its divisions under the Amendment of Commercial Law and the Law for Succession of Labor Contract of 2001.

On the other hand, the Japanese employers reviewed and revised their compensation systems to survive the long depression and competitive markets. Over time, they came to lay weight on performance pay more than basic pay or seniority pay. In this context, most major Japanese firms bid farewell during the 1990s to their life-long employment and their seniority pay structure.

So, it was quite natural that those companies introduced a new scheme into the traditional severance pay plans or DB plans to reflect the performance of employees. This new scheme is called a “Point System” in Japan. A survey conducted by Nikkeiren (Japan Federation of Employers' Association)⁹ showed that 49.4% of surveyed major companies adopted the “Point System” for their retirement benefit plans.

Under the “Point System,” employers give each employee some scheduled points every year according to employee's years of service and job title, and sometimes performance. Points are accumulated through employee's service term and converted into cash by a certain rate at resignation/retirement. If employer emphasizes the point of job title or performance more than service term, the severance pay plan under the “Point System” will reflect more the performance of employees during their service. In this context, the “Point System” looks very similar to a Defined Contribution plan.

Actually, this “Point System” could be described as the first phase of the introduction of new DC plans in Japan because the points under the severance pay plan could be easily converted into the contribution in DC plan. And a DC plan could be more acceptable for employees under the “Point System” severance pay plan.

⁸ Taxable severance pay income = (Severance pay revenue – basic deduction) x 1/2.

Basic deduction = 400,000yen x Y (Y: years of service, Y<20) or

= 8,000,000yen + 700,000yen x (Y-20) (Y: years of services, Y ≥ 20).

⁹ Nikkeiren (<http://www.nikkeiren.or.jp/english/top.htm>) was merged with Keidanren (Japan Federation of Economic Organizations) (<http://www.keidanren.or.jp/index.html>) in April 2002. The new organization is named Japan Business Federation (JBF).

4 New Accounting Rule and Tax Code Changes Drive the DC Plans

The new accounting rule and the Tax Code changes are challenges for the severance pay plan.

On April 1, 2001, a new accounting rule was introduced to help investors better understand the financial situation of the Japanese listed companies. One of the most important changes was the disclosure regarding the liabilities of retirement benefit plans.

It is not necessary that the assets for severance pay be held in a trust arrangement or pursuant to an insurance contract. But according to *the Financial Accounting Standards for Business Enterprises in Japan*, employers are required to appropriate on the balance sheet the amount that assumed to be necessary for severance payments at the end of each accounting term. In short, the companies should reflect the full scope of liabilities of their retirement benefit plans, including severance pay, and show those total liabilities in their finance reports.

But, on the contrary, “Reserves for Retirement Allowance” for severance pay plans will be abolished in near future.

At the end of 1997, the ruling LDP and the Ministry of Finance decided to reduce the corporate income tax rate from 37.5% to 30%. Broken down, the corporate tax rate was 34.5% in FY1998 and 30% in FY1999. To compensate for this drop in corporate income tax revenue, limitations on “Reserves for Retirement Allowance” of the severance pay plans were halved, from 40% to 20%.

The schedule was as below.

FY 1997	40%
FY 1998	37%
FY 1999	33%
FY 2000	30%
FY 2001	27%
FY 2002	23%
FY 2003	20%

In addition, the Ministry of Finance finally decided this year to accelerate the lowering pace and abolish the Reserves altogether in 2006.

In this context, the employers felt that the severance pay plans were not “tax-qualified” anymore. Clearly, from a financial view, firms were loath to assume additional tax burdens. But they were reluctant to eliminate the severance pay plans immediately because the plans have always been very popular with employees. Actually, 67.4% of major Japanese firms offer severance pay plans as well as DB pensions.

Portion of companies that offer retirement benefit plans

	Total	with employees over 1000
Retirement benefit plan	88.9%	99.5%
Severance pay plan only	42.2%	9.6%
DB pension plan	46.7%	89.9%
DB pension only	18.0%	22.6%
DB pension with severance pay plan	28.6%	67.4%

(Ministry of Health, Labor and Welfare, 1997)

This inconsistency between the new accounting rule and the Tax Code seems to drive the introduction of DC plans. In fact, many major companies' CEOs and CFOs are considering setting up a DC plan in order to convert their severance pay plans at first.

5 First Stage of the DC Plans

There isn't much consistency among Japanese companies in establishing DC plans. Some small and medium-sized companies that do not currently offer any retirement benefit plan will introduce a DC plan partly because the initial costs of DC plan are much lower than DB plans. Some companies will abandon all their current retirement plans before setting up DC plans. But, at the first stage in Japan, most seem to favor setting up DC plans by converting current severance pay plan while maintaining the existing DB plan.

In fact, Hitachi announced on September 28, 2001, that it had reached the agreement with its labor union to set up its DC plan by converting half of its current severance pay plans.¹⁰ And newspapers reported that Toyota Motors would convert one-fourth of its severance pay plan to a DC plan and start its contribution from July 2002. Neither company intends to touch their DB plans right now.

How is this conversion done? According to the rules of "DC Plan Law," a company can convert its severance pay plan into DC plan as described below:

- The company can disburse into the DC plan the amount equal to the difference of the liability of the old severance pay plan and the new plan at the time of conversion. If the old plan is to be abandoned, the amount should be equal to the liability at that time.

¹⁰ It offers employer's stock fund as one of eight choices to invest.

- The company should disburse the amount by installments for from three years to seven.
- There is the upper limit of the total amount to disburse. This limit is calculated as if the maximum contribution had been made every year by the employer for each employee while the employee served in the past. The interest rate should also be taken into account. For example, Company A offers TQRP and severance pay plan, and reaches agreement with labor union to convert whole the severance pay plan into DC plan at April 2002. Employee B served A for 20 years.

$$\begin{aligned} \text{The temporary limit of the amount to disburse for B} &= \{216,000 \times (1+r)^{21-n}\} \\ &= 7,865,833\text{yen} \end{aligned}$$

n=1~20

r=5.5% (until 1996), 4.0%(1997), 3.4%(1998), 2.9%(1999), 2.4%(2000), 2.0%(2001)
 (“r” is regulated by Ministry of Health, Labor and Welfare.)

annual maximum contribution for B=216,000yen

The limit of total amount to disburse into DC plan is the aggregate of the limits for each employee.

It is very important that employee can invest the sizable amount from the initial year.

In addition, there are two key dates for DB plans.

The first will be in Fall 2003, when the EPF will be allowed to convert into other DB type plan or DC plan by refunding its substitutional portion to the Government. The Defined Benefit Corporate Pension Law describes that the EPF should refund the amount equal to the “Minimum Required Reserve” when the EPF is converted. This “Minimum Required Reserve” is the amount that the EPF should refund if it resolves and that the EPF is compulsorily required to reserve for the contracted out portion to cover the benefits which are accumulated in the past. In this case, the discount rate is very crucial. Under the current regulations, it is 5.5%. But it is not clear that this 5.5% rate will be used in Fall 2003.

The second key date is March 2012, when the TQRP will be abolished. By this date, the company that currently offers TQRP should convert it into other DB plans or a DC plan.

6 What are the Merits for Employees?

The discussion so far has been from the employers’ viewpoint. But under Japanese employment relations, important changes regarding retirement benefit plans should meet with the approval of union labors or the majority of employees. While the Japanese Trade Union Confederation (Rengo) opposes the introduction of DC plan, why are employees likely to agree with the conversion of the traditional severance pay plan into a DC plan?

Two reasons are possible. Firstly, the employer's contributions are accumulated in the dedicated account for a DC plan and the assets in the account are protected solely for beneficiaries. Severance pay plans, on the other hand, are just book reserved, so that it is never certain whether sufficient financial assets really exist at the time of the payment.

Secondly, accumulated assets in DC plans are portable. What this means is not only that employee can easily change the job but also that employee who changes employer can defer the taxation on severance pay until they turn 60. Under the current Tax Code, the resigning or retiring an employee has to pay individual income tax on the severance pay at the year when he/she resigns and receives the payment.¹¹ Under a DC plan, a worker who changes employers can transfer the accumulated assets in his/her account to the new workplace or Individual-type DC plan (in case of self-employed). Because the resigning employee does not receive his/her severance pay, no income tax is imposed.

7. Conclusion

Now, at the first stage of Japanese DC plans, it seems as though most Japanese companies are responding to the inconsistencies between the new accounting rule and the Tax Code by converting their existing severance payment plans.

But these companies will have to continue to reassess to determine what combination of DB and DC might be best for their retirement benefit plans. This transition period will likely take several years, but change is surely underway.

(End)

¹¹ See note 8.