

# Korea's New Corporate Pension System: Progress and Next Step

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Hanam Phang

Korea Labor Institute  
phang@kli.re.kr

# Korean Pension System

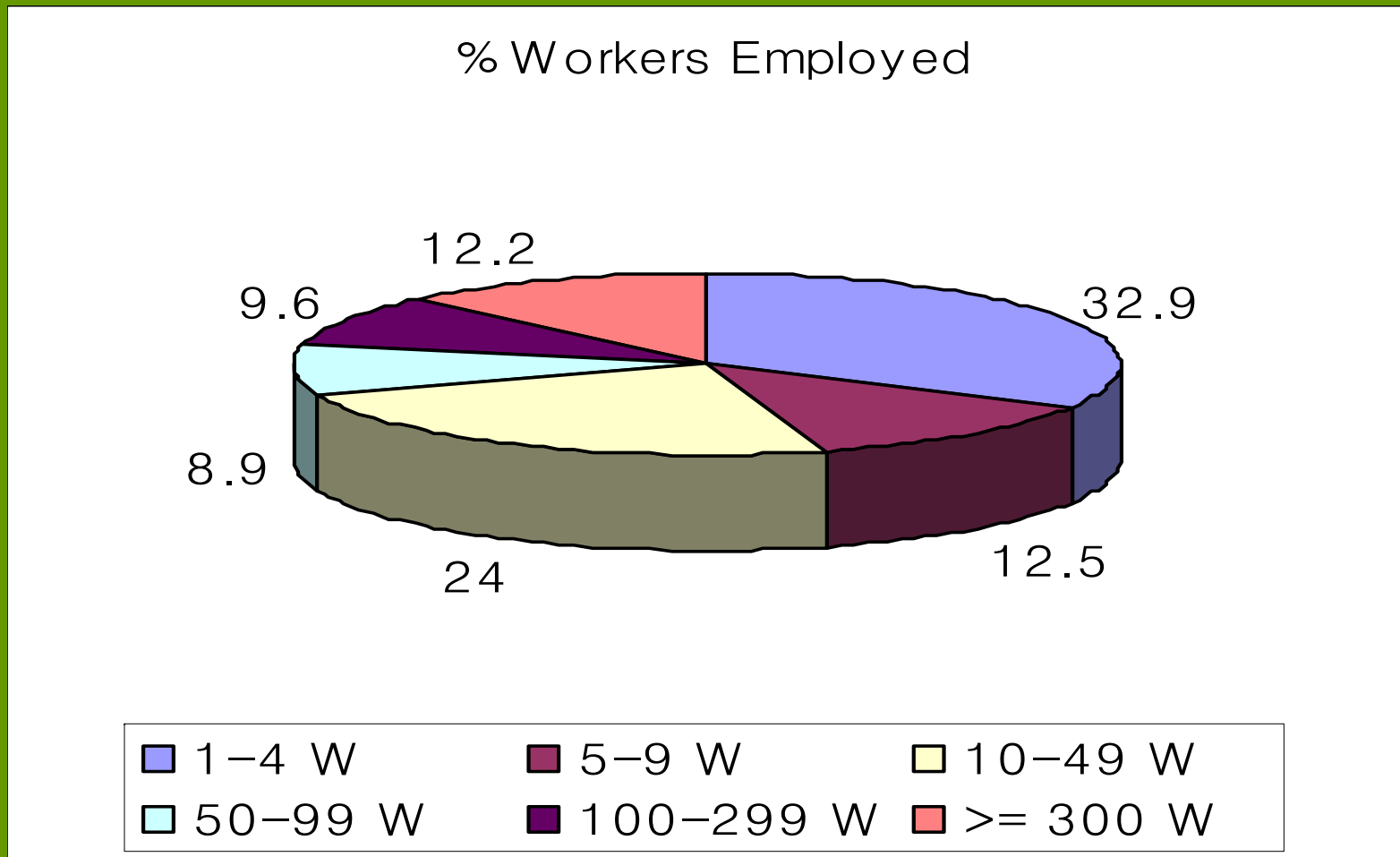
Personal Pension			
Private Pension	<ul style="list-style-type: none"> <li>▪ Retirement Allowance               <ul style="list-style-type: none"> <li>- Severance Pay</li> <li>-Mandatory for firms with <math>\geq 5</math> workers</li> </ul> </li> <li>▪ Retirement Pension (2005) Newly Introduced</li> </ul>	IRA (?) in the future	<ul style="list-style-type: none"> <li>▪ Special Occupational Pension (Public or Private?)</li> <li>-Mandatory</li> <li>- Civil Servants and Professors (Public School)</li> <li>- Military Personal</li> <li>- School Teachers and Professors (Private School)</li> </ul>
Public Pension	<ul style="list-style-type: none"> <li>▪ National Pension Scheme (1988):</li> <li>- Mandatory</li> <li>- Covers all employed workers and the self-employed</li> </ul>		
	<i>Employed Workers</i>	<i>Self-Employed (including farmers)</i>	<i>Civil Servants (+Military)/ Teachers</i>

# Korean Work Force (2004)

Economically Active Population <b>23.4 M</b>			
Employed (96.5%) <b>22.6 M</b>			Unemployed (3.5%) <b>0.8 M</b>
Wage and Salary Workers	Self-employed		
<b>15.0 M (66%)</b>	<b>7.6 M (34%)</b>		
Regular Workers	Irregular Workers	Owner	Family Worker
<b>7.6 M</b>	<b>7.4 M</b>	<b>6.1 M</b>	<b>1.5 M</b>
33.6%	32.7%	27.0%	6.7%

## % Workers Employed by Firm Size

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@ KNSO: Survey of Firms : Basic Statistics, 2003

# Old Scheme: Retirement Allowance / Severance Pay

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- Mandatory (Labor Standard Act, 1953)
  - for Firms with 5 or more employees
  - “to guarantee income for the retired” (Clause 28)
  - Severance Pay (Unconditional – layoff or quit)
  
- Required Contribution:  $1/12 = 8.3\%$  (Employer only)
  - Final Allowance = Final Wage (final 3-month average)\*Number of Years Served
  
- Payable at the time of termination
  - Lump-sum payment
  - Deferred Wage ?

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- Effective Coverage

- About 30% of the Employed Workers (less than 6 Million Wrks)
- Category of Workers Covered = Total Employed – (Workers Employed at Firms with Less than 5 Workers) – (Gov. Employees, Teachers)

- Effective Benefit

- Retirement Allowance grows exponentially with Tenure
  - (internally grows with wage increase b/c based on the final wage)
- About 25% Income Replacement Effect (World Bank, 2000) *if well funded and well managed for 35 years*

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## ○ Work Life of Korean Workers

- Average tenure of the Korean workers = 5~6 years
- Work Life ? (about 25 years for Employed Workers) – late entry and early (forced) retirement (about age 55) (see *Phang (2000): Work Life Profiles of Korean Workers*)
- Large Variation between Sex and by Educational Levels in terms of Length and Continuity

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- Funding and Reservation

- Largely unfunded and book-reserved

- Limited Guarantee by Wage and Retirement Income Guarantee Fund (3-year, 3-month worth of wage/allowance)
- Only about 40% Funded Outside in the Form of Retirement Allowance Insurance
- Large Hidden Liability for the Firms (total estimated = 60 trillion Won)

- Advance Pay-off Allowed by Workers' Request

- More than 30% of the Firms already paid off their retirement allowance as of 2000

## Where Retirement Allowance is Used /Spent

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Where	Ratio(%)
Basic Living Costs	53.1
Savings or Investments	20.9
Business Start-up Fund	4.3
Vocational Training or Education Fee	4.1
Housing Purchase/Moving/Rent and etc.	4.6
School or Marriage Cost for Children	3.5
Debts Repayment	7.6
Other	2.1

## *Are You Preparing for Retirement Income?*

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● <i>Not Preparing at All</i>	<i>69.1%</i>
● <i>Preparing Personally</i>	<i>31.9%</i>
● <i>Personal Pension</i>	<i>15.9%</i>
● <i>Savings</i>	<i>13.6%</i>
● <i>Real Estate</i>	<i>3.8%</i>
● <i>Retirement Allowance</i>	<i>2.3%</i>
● <i>Other</i>	<i>0.5%</i>

*Source: KNSO Survey of Social Indicators, 2003*

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- Ageing Society and Weakening Family Support
  - Problems with the National Pension Scheme
    - Contribution Rate: 9% -> 15%
    - Pension Benefit: 70% -> 60% -> 50%
    - Uneasy Task of Keeping the System Solvent
  - Personal Pension market only weakly developed
    - Market Failure or Government Failure?
    - Need to be More Developed

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- Retirement Allowance -> Retirement Pension
    - Strong Need for the 2nd-tier Old-age Income Security
    - But Current Scheme: Largely Unfunded, Low Guarantee, Low Preservation, No Management
    - Retirement Allowance could be a good funding source for the 2nd-tier Old-age Income Security

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- New Retirement Pension introduced
    - Newly introduced as of 2005
    - Defined Benefit or Defined Contribution
    - IR(S)A as a Terminal or Transitory Savings Vehicle
    - Transition is Voluntary - Limits
    - Same Contribution Rate (8.3%) for DC
    - DB benefit  $\geq$  current Retirement Allowance

# Reformed RAS: Korean ERISA

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## A. Defined Benefit Retirement Plan

- (1) The DB plan, as it is described in the draft act, is not like the classical DB plan as it is known, but a pseudo-DB plan in that it is actually a revised RAS Insurance plan (introduced in 1999), a kind of outside deposit vehicle for unfunded RAS liabilities.
- (2) So, the minimum level of funding = 60%, stipulated by the law but allowed to be negotiated between employer and employees ‘taking the company’s business condition into account’.

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## A. Defined Benefit Retirement Plan

- (3) Under the DB plan, clear statement of benefit entitlements should be included in the plan contract including the type and method of benefit payments.
- (4) The level of benefit promised under the plan should be actuarially equivalent to or no less than the final RA payment under current mandatory RAS ( - which makes conventional design of DB plan very difficult)
- (5) Benefits could be disbursed at the end of contract either in lump-sum or in annuity (\* plan holders with more than 10 years' participation and aged 55 are recommended to buy annuity and get tax-treatment)

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## B. Defined Contribution Retirement Plan

- (1) Employers who install DC plan instead of RAS should contribute no less than 8.3%(1/12) of the payroll to its retirement plan
- (2) The DC plan should be funded and managed under either Insurance or Trust Contract (to protect workers' benefit rights in case of bankruptcy of the employer or the financial institution)
- (3) Under DC plan, one of the investment options to employees should be GIC (Guaranteed Income Contract)
- (4) The final DC pension benefit could be variable, unlike under DB plan. Payment could be made by lump-sum or in annuity.

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## C. IRA (Individual Retirement (Savings) Account)

- (1) IRA is a kind of transitional or terminal savings account for job movers who could deposit their lump-sum payments from their last employer's RAS, DB or DC plan until normal retirement age( $\geq 55$ )
- (2) IRA will be contracted and regulated as DC plan: The difference is that IRA is an individual savings account detached from any specific employer's plan
- (3) Rules and regulations against mis-selling and for safety of individual account holders (including provision of information and education) will be arranged

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## D. Coverage and Implementation

- (1) With the introduction of CP, the coverage will be extended to all firms with less than 5 employees
- (2) Firms with less than 10 employees could set up IRA plan in place of RAS for their employees' retirement benefit
- (3) Implementation of the extended application will be deferred until 2007
- (4) mandatory contribution rate will be set at  $\frac{1}{24}$  (for 2007-2008),  $\frac{1}{20}$  (for 2009-2010),  $\frac{1}{16}$  (for 2011-2012) instead of  $\frac{1}{12}$  under current RAS

# Issues and Challenges for Next Step

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- Transition Incomplete or Undergoing
  - Old Scheme and New Scheme Co-Existing
  - Transition in up to Management-Union Agreement
  - Could take longer than expected unless strong Policy Intervention
    - (ex: Japanese case)
  - Preferred Tax Treatment on the New Scheme is strongly Needed
    - Tax Break for the Unfunded Portion of the RA should be Reduced
    - Currently 40% to 20% to ultimately 0% by 2010
  - Or could mandate the transition from RA to RP by 2010
    - Employer's Response
    - Employee's Response

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○ DB or DC? Or Both? Choice Problem

- Options are diverse, but Diversity does not guarantee rational choice
- National Pension (1<sup>st</sup>-tier) = DB; Corporate Pension (2<sup>nd</sup>-tier) = DC should be a good combination, Global Trend
- The Relevance and Utility of the DB Plan in general, Questionable in Korean context (given the average longevity of firms and tenure of workers)
- Multi-Employer Plan or Industrial-level Retirement Pension Fund might be a long-term rational solution for ‘Economies of Scale’ and ‘Admin. Cost Problem’

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- Little Incentive for the New Scheme

- Old Scheme: Special Tax Treatment, No Market Risk (RA grows with the internal wage increase)
- New Scheme:
  - DB Plan => Little Incentive to Employer (Cost of Funding)
  - DC => Little Incentive to Employees (Risk of Investment)
- Resolving those Negative Incentives is a Key to Mobilizing Employers and Employees to the New Scheme

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- Additional Contribution from Employee to RP Plan

- Voluntary Approach, but Formal Process Not Specified
- Contribution Limit Set to 3 Million won (including Contributions to Personal Pension (limit = 2.4 M))
- Personal Pension (3<sup>rd</sup>-tier) Policy Need to be Reformed into IRA Scheme (ex. USA)

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- IRA Plans Worried

- RP Plan for Small-sized Firms ( $= < 10$ )
- Used as a Vehicle for Annual Pay-off of the Retirement Allowance
- Individual Contract: Not Much Different from Firm-sponsored Personal Pension
  - Would their Market Outcome be Better than the Pre-existing Personal Pension Products?
  - Would they be managed and invested according to Prudent Men's Rule?
- Policy Holders, Very Mobile and Unstable Workforce → Difficult to Monitor and Evaluate
- Record Keeping and Regulation Also Costly

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○ Labor Mobility and Vesting Right of the Retirement Pension

- No Explicit Vesting Right's Rule
- RA Rule (1 year, 100%) applied to the Retirement Pension
- High Mobile Workers  $\Rightarrow$  High Management Cost and Record Keeping Problem
- Maybe Paid-off by Retirement Allowance, then, their Old-age Income Security threatened
- Alternative: 5-Year Rule (if less than 5 year, then, lump-sum RA paid-off, if more than 5-year, then 100% vesting right provided)

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- Pension Benefit Guarantee for DB Plans
    - Under Study (PBGC(U.S.A.), PPF-TPR(B.K.), FPG/PRI (Sweden))
    - Needed for the DB Plans and the Retirement Allowance Schemes
    - Minimum Return Guarantee for the DC Plans?
      - DB Plans = Minimum Pension Benefit Mandated to be  $\geq$  RA Benefit
      - No such Guarantee for DC Plans (except GIC options)
    - Regulation on Funding for DB plans is not Stipulated
      - Pension Provider's Market is regulated by Korean FSA
      - Monitoring and Regulation over Plan Sponsors (Employers) by the Ministry of Labor?
    - Reform of the Wage Guarantee Scheme into Pension Benefit Guarantee Scheme: under study

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- Coordinated Development with the National Pension
    - For Multi-Pillar Old-age Income Security
    - Retirement Pension Scheme Need to be more formalized and developed into a genuine 2<sup>nd</sup>-pillar Pension
      - World Bank, OECD, ILO's recommendations
    - Division of Role between the NP and RP need to be Determined
      - Contribution Rate: 9.0% -> 13% (NP) and 8.3% (RP)
      - Benefit-Level: 30-50% by NP and 20-30% by RP
      - Record Keeping and Management
    - RA, 100% funded by Employer by Korean ERISA

No. of Firms Adopting the New Scheme : Total 16,664  
( 3.5% of Firms Applicable (>=5 Employees, 471,000)

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	<b>Total</b>	<b>DB Plan</b>	<b>DC Plan</b>	<b>DB &amp; DC</b>	<b>IRA</b>
<b>Firms Adopting</b>	<b>16,664</b>	<b>1,803</b>	<b>5,518</b>	<b>84</b>	<b>9,259</b>
<b>(%)</b>	<b>100</b>	<b>10.8</b>	<b>33.1</b>	<b>0.5</b>	<b>55.6</b>

## No. of Firms Adopting the New Scheme by Plan Type

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	No. of Firms	DB Plan	DC Plan	DB & DC	IRA
<b>Employees &gt;= 500</b>	<b>61</b>	<b>24(39.3)</b>	<b>17(27.9)</b>	<b>20(32.8)</b>	
<b>Employees &lt; 500</b>	<b>16,603</b>	<b>1,779(10.7)</b>	<b>5,501(33.1)</b>	<b>64(0.4)</b>	<b>9,259(55.8)</b>

Total = 16,664 ( 3.5% of Firms Applicable (>=5 Employees, 471,000))

**No. of Workers Joined the New Scheme :**  
**N = 218,338**

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	Total	DB Plan	DC Plan	IRA
<b>No. of Workers Joined (%)</b>	<b>218,338 (100)</b>	<b>84,880 (38.9)</b>	<b>97,029 (44.4)</b>	<b>36,429 (16.7)</b>
<b>Avg. Member per Plan</b>	<b>13.9</b>	<b>50.0</b>	<b>20.4</b>	<b>3.9</b>
<b>Fund Amount (%)</b>	<b>7,788 (100)</b>	<b>5,090 (65.4)</b>	<b>2,184 (28.0)</b>	<b>514 (6.6)</b>

## Number of Firms Adopting the New Scheme

	Size of the Firm				
	10 ~ 29	30 ~ 99	100 ~ 299	300 ~ 499	>= 500
No. Firms Adopting	3,331	1,573	318	30	61
Total No. of Firms	142,198	41,469	8,138	1,101	983
(①/②)(%)	2.34	3.79	3.91	2.72	6.21