Korea’s New Corporate Pension System: Progress and Next Step


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## Korean Pension System

<table>
<thead>
<tr>
<th>Type</th>
<th>Description</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Personal Pension</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private Pension</td>
<td>• Retirement Allowance - Severance Pay - Mandatory for firms with &gt;=5 workers</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Retirement Pension (2005) Newly Introduced</td>
<td></td>
</tr>
<tr>
<td>Public Pension</td>
<td>• National Pension Scheme (1988): - Mandatory - Covers all employed workers and the self-employed</td>
<td>- Mandatory - Military Personal - School Teachers and Professors (Public School) - Civil Servants and Professors (Private School)</td>
</tr>
</tbody>
</table>

### Employed Workers
- Self-Employed (including farmers)

### Civil Servants (+Military)/Teachers

<table>
<thead>
<tr>
<th>Economically Active Population</th>
<th>23.4 M</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employed (96.5%)</td>
<td>22.6 M</td>
</tr>
<tr>
<td>Unemployed (3.5%)</td>
<td>0.8 M</td>
</tr>
<tr>
<td>Wage and Salary Workers</td>
<td>Self-employed</td>
</tr>
<tr>
<td>15.0 M (66%)</td>
<td>7.6 M (34%)</td>
</tr>
<tr>
<td>Regular Workers</td>
<td>Irregular Workers</td>
</tr>
<tr>
<td>7.6 M</td>
<td>7.4 M</td>
</tr>
<tr>
<td>33.6%</td>
<td>32.7%</td>
</tr>
</tbody>
</table>
% Workers Employed by Firm Size

@ KNSO: Survey of Firms: Basic Statistics, 2003
Old Scheme: Retirement Allowance / Severance Pay

○ 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 ?
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*
○ Work Life of Korean Workers

- Average tenure of the Korean workers = 5~6 years


- Large Variation between Sex and by Educational Levels in terms of Length and Continuity
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

<table>
<thead>
<tr>
<th>Where</th>
<th>Ratio(%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic Living Costs</td>
<td>53.1</td>
</tr>
<tr>
<td>Savings or Investments</td>
<td>20.9</td>
</tr>
<tr>
<td>Business Start-up Fund</td>
<td>4.3</td>
</tr>
<tr>
<td>Vocational Training or Education Fee</td>
<td>4.1</td>
</tr>
<tr>
<td>Housing Purchase/Moving/Rent and etc.</td>
<td>4.6</td>
</tr>
<tr>
<td>School or Marriage Cost for Children</td>
<td>3.5</td>
</tr>
<tr>
<td>Debts Repayment</td>
<td>7.6</td>
</tr>
<tr>
<td>Other</td>
<td>2.1</td>
</tr>
</tbody>
</table>
Are You Preparing for Retirement Income?

- Not Preparing at All  69.1%
- Preparing Personally  31.9%
  - Personal Pension  15.9%
  - Savings  13.6%
  - Real Estate  3.8%
  - Retirement Allowance  2.3%
  - Other  0.5%

Source: KNSO Survey of Social Indicators, 2003
• 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
- 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
- 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 >= current Retirement Allowance
Reformed RAS: Korean ERISA

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’.
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)
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.
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(>=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
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

- 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
DB or DC? Or Both? Choice Problem

- Options are diverse, but Diversity does not guarantee rational choice
- National Pension (1\textsuperscript{st}-tier) = DB; Corporate Pension (2\textsuperscript{nd}-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’
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
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 (3rd-tier) Policy Need to be Reformed into IRA Scheme (ex. USA)
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
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 ⇒ 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 then 5-year, then 100% vesting right provided
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 >= 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
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 2nd-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)

<table>
<thead>
<tr>
<th>Firms Adopting</th>
<th>Total</th>
<th>DB Plan</th>
<th>DC Plan</th>
<th>DB &amp; DC</th>
<th>IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>16,664</td>
<td>1,803</td>
<td>5,518</td>
<td>84</td>
<td>9,259</td>
</tr>
<tr>
<td>(%)</td>
<td>100</td>
<td>10.8</td>
<td>33.1</td>
<td>0.5</td>
<td>55.6</td>
</tr>
</tbody>
</table>
### No. of Firms Adopting the New Scheme by Plan Type

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

Total = 16,664 (3.5% of Firms Applicable (>=5 Employees, 471,000)
No. of Workers Joined the New Scheme:
N = 218,338

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>DB Plan</th>
<th>DC Plan</th>
<th>IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>No. of Workers Joined (%)</strong></td>
<td>218,338 (100)</td>
<td>84,880 (38.9)</td>
<td>97,029 (44.4)</td>
<td>36,429 (16.7)</td>
</tr>
<tr>
<td><strong>Avg. Member per Plan</strong></td>
<td>13.9</td>
<td>50.0</td>
<td>20.4</td>
<td>3.9</td>
</tr>
<tr>
<td><strong>Fund Amount (%)</strong></td>
<td>7,788 (100)</td>
<td>5,090 (65.4)</td>
<td>2,184 (28.0)</td>
<td>514 (6.6)</td>
</tr>
</tbody>
</table>
## Number of Firms Adopting the New Scheme

<table>
<thead>
<tr>
<th>Size of the Firm</th>
<th>10 ~ 29</th>
<th>30 ~ 99</th>
<th>100 ~ 299</th>
<th>300 ~ 499</th>
<th>&gt;= 500</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>No. Firms</strong></td>
<td>3,331</td>
<td>1,573</td>
<td>318</td>
<td>30</td>
<td>61</td>
</tr>
<tr>
<td><strong>Total No. of</strong></td>
<td>142,198</td>
<td>41,469</td>
<td>8,138</td>
<td>1,101</td>
<td>983</td>
</tr>
<tr>
<td><strong>Firms</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>(①/②)(%)</strong></td>
<td>2.34</td>
<td>3.79</td>
<td>3.91</td>
<td>2.72</td>
<td>6.21</td>
</tr>
</tbody>
</table>

Number of Firms Adopting the New Scheme