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The Emerging Era of Corporate Pensions in Korea

by George Beram

A new occupational, or corporate, pension law (the Employee Retirement Security Act or "ERSA") was passed by the Republic of Korea (South Korea) National Assembly on Dec. 29, 2004. It will allow for private sector defined benefit (DB) and defined contribution (DC) pension plans for the first time in the world's 10th largest economy (in 2004 based upon GDP according to the Korean Ministry of Commerce, Industry and Energy). The law will require many regulations to be issued by the ministries of labor, finance and other governmental agencies before, and after, the Dec. 1, 2005 effective date; importantly, on tax issues, funding rules for defined benefit plans, and fiduciary obligations. What follows is the situation as of the end of September 2005 as all the usual suspects—employers, employee groups, financial institutions, consultants, system providers and others—are jockeying for position for control of a share of the new Korean pensions market.

ERSA is limited legislation in many respects and it should be considered a beginning to solving the pension crisis facing Korea, which is not unlike crises being faced by many other aging, developed countries. But the situation in Korea may be more serious than most because of an overambitious social security system, the lack of private sector occupational pensions in the past and a population that is aging at a very rapid pace.

It should be noted that employees of the government in Korea and certain other groups, are covered by generous defined benefit plans which is not unlike the evolving pension situation in the United States, United Kingdom and other countries where most private sector workers appear to fare poorly in comparison to governmental workers. This article is focused on the private sector.

I will begin with a look at the Korean retirement system, as it has existed before ERSA, followed by a review of the new law, options to be considered by employers and some of the issues to be resolved. Assuming enough employers actually adopt corporate pensions soon after Nov. 30, 2005, a follow-up article in a year or so may be of interest.

Korean Retirement System before the Employee Retirement Security Act (ERSA)

The Korean retirement system currently consists of the following,

- National Pension Scheme (social security),
- Mandatory "retirement allowance" plans, and
- Personal pensions.

The National Pension Scheme began in 1988 and its primary features are:

- Target pensions of 60 percent (expected to be decreased to 50 percent or lower) of final salary for the average worker with 40 years in the system,
- A normal retirement age of 60 (expected to be increased to 65), and

- A funded but unsound system at a 9.0 percent contribution rate (split between employers and employees).

The mandatory retirement allowance (RA) plans ("retirement" may be a misnomer) provide lump sum termination indemnities similar to those in Italy, Brazil and other countries, with features as follows.

Minimum Benefit
Final average monthly salary (three months) x years of service (paid as a lump sum immediately upon termination or retirement; an annuity could be purchased, but is almost never done). A number of Korean companies provide "progressive" benefits that are greater than the mandatory minimum.

Defined Benefit System
RA plans are technically considered defined benefit plans under IAS 19 and FAS 87 unless accrued benefits are consistently paid out to employees at the end of each year (called "advance payments") which is a practice followed by a number of Korean companies.

Lump Sum Driven
Tax laws in Korea provide a significant incentive for employees to take a lump sum, and close to 100 percent of employees actually take a lump sum.

Limited Use for Retirement
Studies show most retirement allowance benefits (about 80 percent) are paid upon termination before retirement (or as advance payments) and are used for purposes other than directly providing retirement income.

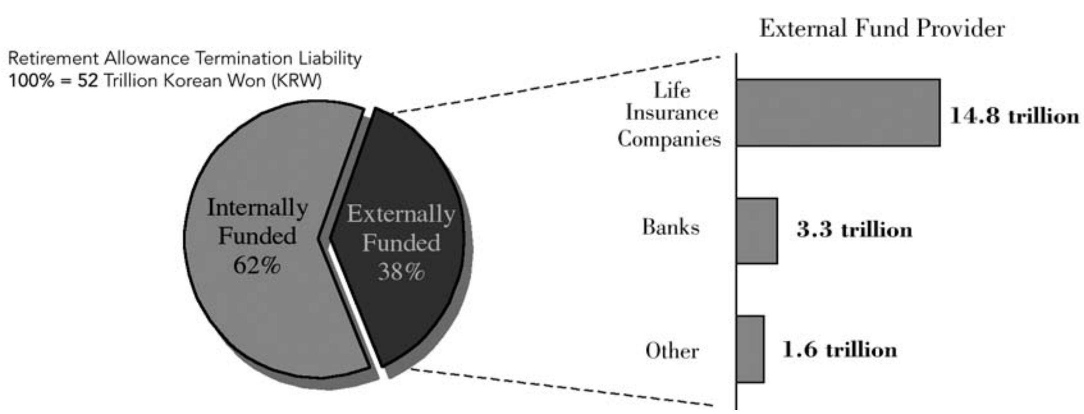
Funding
RA plans may be internally (book reserve) funded, externally funded, or both, with tax exemption up to certain limits.

While the primary goal of ERSA is that employers replace RA plans with DB and DC plans, the retirement allowance system began in the 1960s and is an entrenched employee benefit in Korea notwithstanding its many drawbacks. Replacing mandatory RA plans with DB and DC pension plans (it will be up to employers to choose—with employee consent required) will not be easy, and that explains the very limited nature of DB and DC options under ERSA. The DB and DC plans look like RA plans; something that many hope will change over time.

What will drive the change, if regulations are strong enough, is the elimination of the current tax incentive (virtually no tax) to take a lump sum under an RA plan combined with incentives to annuitize. The phase-out of tax deductions for internally funded RA plans combined with the phase-out of external funding vehicles for these plans, the latter being a provision of ERSA, will also drive the change.

The approximate current funded status and market share of fund providers of externally funded mandatory retirement allowance plans (employers with 30 or more employees at the end of 2004) is shown on the chart below (*sources: Ministry of Labor and Samsung Life*).

continued on page 34



Retirement allowance plans for employers with five to 30 employees, a substantial part of the working population, might add roughly another 30 to 50 trillion KRW of liability, and are not included in the chart. Most of these small employers do not externally fund RA plan liabilities.

Personal pensions are similar to IRAs in the United States with a tax-exempt contribution limit of about $2,400 a year. They are not widely used. Retirement allowance benefits cannot be rolled over to a personal pension account.

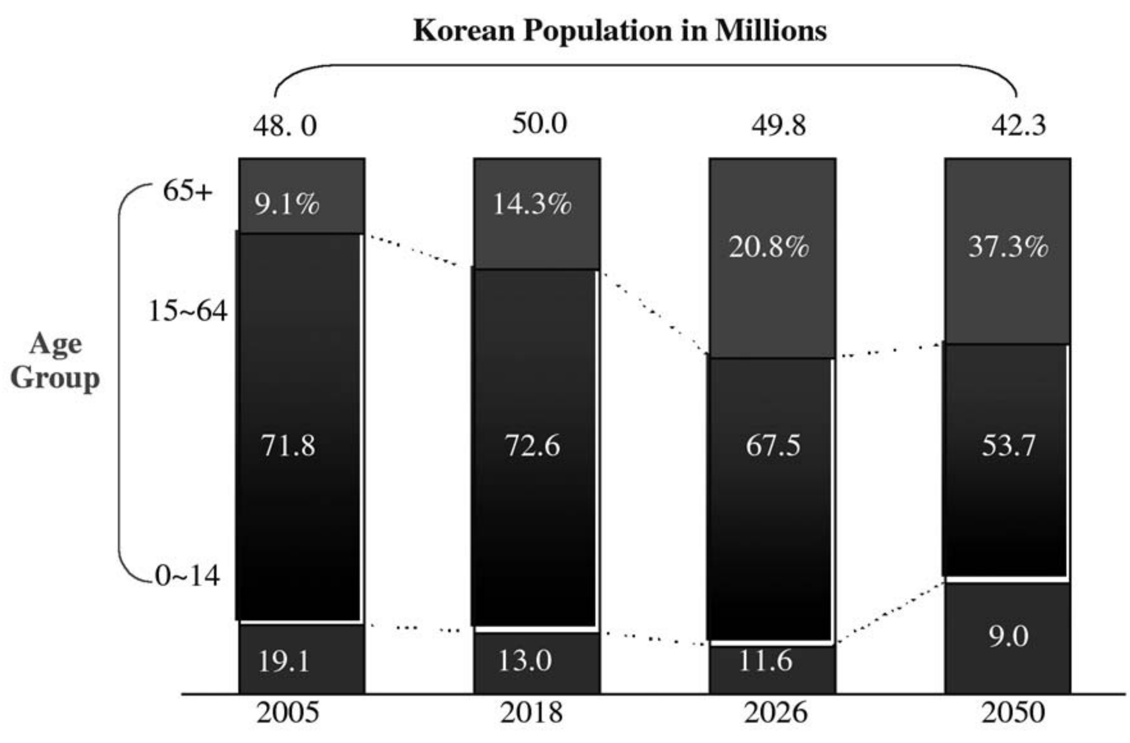
Rationale for Adoption of the New Korean Employee Retirement Security Act

A number of factors have led to the passing of ERSA:

- Recognition that the National Pension Scheme (NPS) cannot deliver promised benefits at a 9.0 percent contribution rate (at least 15 percent to 20 percent would likely be needed);
- A rapidly aging population (see the following chart below) with, possibly, the world's lowest birth rate;
- The rapid decline of extended family care for elders, and the growth of individualism;
- The need to provide for a gradual transition from mandatory retirement allowance plans to corporate pensions of the type prevalent in Japan and in such countries as the United States, Germany, Canada and the United Kingdom; and
- The need to transition much of the internal book reserve funding under the RA system to external funding in order to provide greater security for employees and provide additional capital for Korean financial markets (although Professor Klaus Heubeck has recently written, with regard to Germany, that internally funded book reserve systems remain a viable way of meeting pension liabilities).

The rapid aging of the Korean population is shown in the following projections made by the National Statistical Office of Korea (January 2005).

While most developed, and some undeveloped, countries are aging, Koreans may be aging at one of the fastest rates.



	Retirement Allowance	Defined Benefit	Defined Contribution
Minimum Benefit (if lump sum)	Average of Final 3 Months' Salaries x Service	Average of Final 3 Months' Salaries x Service	Account Balance
Funding (Employer)	Internal and/or External (5 year limit on the latter)	External Funding - Rules to be Determined	Full External
Funding Basis	Employer Discretion	Actuarial Determination*	8.3 Percent of Salary Each Year (min.)
Tax Consequences (Generally EET for DB and DC Plans)	Deduction for Internal Funding up to 40 Percent of Expense (expected to be phased out); Deduction for External Funding Ends on December 31, 2010	Full Deduction for External Funding	Full Deduction for External Funding
Withdrawals Before Retirement or Termination	Advanced Payments Allowed (data is limited but as many as 30 percent of employers may make advance payments on a regular or irregular basis)	• No Advance Payments • Loans up to 50 Percent of Accrued Benefit	• No Advance Payments • Loans up to 50 Percent of Account Balance • Hardship Withdrawals
Benefit Form	Lump Sum	Lump Sum/Annuity	Lump Sum/Annuity
Portability to an IRA	No	Yes	Yes
Assets	Fixed Income Securities through Retirement Insurance/Trust Contracts	Fixed Income and Equity Funds to be Available from "Providers" (life companies, banks, securities firms and others) There May, by Regulation, Be a Limit on the Percent of Equities in a DB Plan Fund	Fixed Income and Equity Funds (at least three) from "Providers" with a 40 Percent Limit on Equities in an Employee's Account Balance and One Fund Must Provide a Guarantee of Principal and Interest Employees Select from Among the Funds as in U.S. 401(k) Plans
Employee Consent Requirement	No	Yes	Yes

** Regulations may also allow a non-actuarial method for calculating DB funding amounts such as the increase in plan termination liability from one year to the next where the liability is simply the amount to be paid out if all the employees then terminated.*

continued on page 36

Summary of ERSA

ERSA is relatively simple (however, regulations will change that) and provides limited choices for employers. Briefly, there will be three practical options for employers:

- *Continue a mandatory retirement allowance (RA) plan,*
- *Adopt a defined benefit (DB) pension plan in place of an RA plan, or*
- *Adopt a defined contribution (DC) pension plan in place of an RA plan.*

If an employer chooses a DB or DC plan it will be possible to retain the RA plan for benefits accrued to the date of change.

A fourth option may be to allow employees to choose either a DB plan or a DC plan, which means the employer would end up sponsoring two pension plans.

It is likely that employers with union and non-union groups or with several subsidiary companies may choose DB plans for some and DC plans for others.

Over time, regulations and amendments to the law may increase the options (e.g., cash balance plans as allowed in Japan and maybe again in the United States). In choosing among pension plan options, employers will also need to address some difficult issues arising from the transition from RA to DB plans or RA to DC plans, a subject beyond the scope of this article. As might be expected, one of the big questions is whether DB or DC plans will predominate.

The chart on page 35 presents a brief comparison of mandatory retirement allowance, defined benefit and defined contribution plans under ERSA, effective Dec. 1, 2005 and, again, based upon information available at the end of September 2005.

Plan Options for Employers: Pros and Cons

In outline form we have the following options.

1) An employer could decide to continue to provide a mandatory RA plan on and after Dec. 1, 2005.
    - *A "do nothing" approach.*
    - *The simplest and easiest solution for now, particularly if regulations are not clear and formalized.*
    - *But the employer will almost certainly lose current tax advantages for internal funding. Forty percent of internal funding expense for RA plans is currently tax deductible, however, this is expected to be phased out (a reduction to 30 percent has been approved for 2006, with likely further reductions to 20 percent in 2007, 10 percent in 2008 and zero percent in 2009).*
    - *If externally funded, retirement insurance/trust contracts currently used to fund RA plans must end within five years and no new retirement insurance or trust contracts are allowed after November 30, 2005 for employers who had not set up such a contract before then.*
    - *Possible negative effect on employees' perception.*
    - *At best, a short-term solution.*

2) Adopt a DB plan in place of an RA plan.
    - *Most similar to a retirement allowance plan, easiest to explain to employees, and strongly favored by unions.*
    - *Probably more flexible funding levels, including a possible provision for retention of a certain level of internal book reserve funding, compared to a DC plan.*
    - *Possible volatility in financial statement expense (see below).*
    - *Simpler annual administration than DC.*
    - *Transition from an RA plan to a DB plan should be simpler than a transition to a DC plan.*

3) Adopt a DC plan in place of an RA plan.
    - *Requires 8.3 percent (one-twelfth) of annual salary to be contributed to each employee's account (full external funding).*
    - *The ultimate benefit depends upon investment performance from funds offered by the employer and selected by the employee.*

- *Complex recordkeeping system is necessary, which is the provider's problem, but can also affect employers.*
- *Investment education is required to be given to employees.*
- *More complex transition issues (than DB) from RA plans.*

4) Give employees a choice of a DB or a DC plan (if allowed by regulation).
   - *i.e., some employees will choose DB and some will choose DC.*
   - *Reduces or eliminates employee consent issues.*
   - *But the employer will be sponsoring two pension plans instead of one, which may be impractical.*

Financial Accounting

Korean-based companies generally do not follow IAS 19, FAS 87 or other actuarially based standards on accounting for the cost of retirement allowance plans. However, the Korean Accounting Standards Board (KASB) is considering adoption of IAS 19 or a version of it in the near future (Korea follows Japan and the United States in many respects, and here the KASB is probably looking at the Japanese standard).

Korean subsidiaries of the European Union, United States, United Kingdom and other multinationals, generally comply with IAS 19, FAS 87, and other such actuarially based standards for their Korean RA plans, except where annual advance payments are the rule.

Given what has happened in other countries, some Korean employers are concerned that adoption of a DB plan will have an adverse effect on their financial statements.

Retirement Age

The Korean NPS normal retirement age is currently 60 and is expected to be increased to 65. Most Korean companies have a normal retirement age of 55, which could be applied to DB and DC plans under ERSA. However, there will very likely be a labor shortage in the future due to demographic changes if the country's financial forecasts for economic growth are to be met. Therefore, should employers raise the normal retirement age if and when a corporate pension plan is established? What are the cost and other consequences of raising the retirement age, and is this an opportunity to introduce a phased retirement system?

In summary, this article presents the situation at the end of September 2005, as Korea is attempting a sea change in the delivery of retirement income to its citizens, I have briefly described the new pension law and touched on some of the major problems to be faced by the country, employers and employees in establishing a secure and affordable three-pillar system. The tough question is: Can a successful occupational pension system be implemented, and can it be done in time—meaning the race between the accumulation of retirement assets and the rapidly aging population? All we can say now is that ERSA is a first, limited step in changing the country's retirement system and that, at least, should be of great interest to our profession. Of particular note is that while many financial institutions are preparing products and services for the new corporate pension market, there may not be, at present, sufficient numbers of pension consultants and actuaries in Korea to assist in the complex work that must be done. □

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