Is Corporate Pension System Flexible Enough?

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Flexibility is being pitched by the government as one of the key selling points for the new corporate pension system — but what does "flexibility" mean and are we making the most of it?

At the highest level, flexibility seems to mean choice over the structure of the pension plan. One of the key features of the new legislation is the introduction of Defined Contribution plans, which has brought a whole new range of plan structures to the market. This is the area of flexibility where companies have been most active with many looking to replace their old Severance Pay plans with Defined Contribution plans.

Then looking one level down, the new legislation has also brought more flexibility over the design of benefits. We still have the mandatory minimum rules but many companies are now looking at interesting and innovative designs that go beyond the minimum rules. Again, this has been particularly true for those companies looking to implement Defined Contribution plans.

But what about beyond this? Is there more flexibility within the legislation and are companies making use of it? The answers to these questions are probably; yes, there is more flexibility within the legislation but no, companies are not really making the most of it yet.

One key area where there is unused flexibility is around employee contributions. Under the new legislation, employees are allowed to contribute to the corporate pension system and (up to certain limits) the contributions are made before the payment of income tax — which makes this a tax efficient vehicle for employees to save into.

Employee contributions to pension plans are common around the world and there are a number of good reasons for this; it shares the cost of the plan with the employees, it encourages employees to take responsibility/ownership for their retirement and quite often (as in Korea) it is tax efficient for employees to contribute to the pension plan.

There is also flexibility over how employees can contribute. Employers can force the workforce to contribute or they can give employees the option to participate in the plan. There are pros and cons of either approach but as employee contributions are a new concept in Korea it's likely that an optional system will work best for now.

One system for employee contributions that is commonly used in the United States and Europe is the idea of a "matching" plan. Employees are given the option to contribute to the pension plan and if they do so then the employer will match these contributions (up to some pre-determined limit).

The key advantage of this matching system is that an employee gets a clear benefit for contributing to the pension plan — for every dollar he puts in, his company also puts in a dollar...up to the limits set out in the plan rules.

The Korean legislation is clearly set up to allow employee contributions and we are now seeing companies start to show some interest in this type of arrangement. As the Korean pension system matures it seems likely that employee contributions — potentially via matching arrangements — emerge as a common feature of the plan design.

The second key area of untapped flexibility is around the format of the retirement benefits. Under the Severance Pay system benefits can only be paid out as a cash "lump sum" but the new legislation also allows employees the option to receive the benefits as a series of payments. This type of format allows employees to spread the receipt of the benefit over their retirement and is referred to as an "annuity" format.

Paying retirement benefits in annuity format is consistent with how an employee receives salary payments up to retirement and can make the benefit easier for an employee to manage income assets effectively. For this reason, legislation in some countries forces employees to take at least some of their retirement benefit in annuity format.

However, this option has not been popular in Korea so far and there are a couple of reasons for this. The first one is culture or habit. Employees are used to receiving their Severance Pay benefits in lump sum format and do not like the idea of changing this system — even if there are clear tax (and other) advantages to doing so. This is almost human nature; individuals don't often like change and they tend also to place a higher value on cash now rather than payments in the future.

The second reason is that it is actually quite difficult — and expensive — for employees to convert their lump sum into an annuity in Korea. Typically life insurance companies operate in this market and will offer 'conversion terms' for employees to exchange their lump sum benefit for the equivalent annuity payment. At the moment there are very few life insurance (or other) companies in Korea offering this service and even if they are, the terms are very uncompetitive and so few employees are considering this option.

It's likely that this annuity market will grow as the new corporate pension system matures. The government is clearly encouraging employees to consider the annuity option — via generous tax treatment — and it is likely to only be a matter of time before life insurance companies see the opportunities in this area.

As the new pension market moves towards maturity it seems likely that the government's predictions of flexibility will be borne out. We are already seeing diversity in the types of pension plans on offer and there are clear opportunities for the system to develop further. Employee contributions and the use of the annuity option will both be welcome additions to Korea's pension system and will bring it even closer to the comprehensive systems adopted by other major economies.