# Corporate Pension Faces Long-Term Challenges

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South Korea's population is aging. Families are having fewer children, and more Koreans are entering their retirement years. With the country's demographics shifting, securing financial protection in retirement has become more of a concern than before.

Late last year, the South Korean government introduced a new retirement pension plan in an effort to boost the country's pension program. Fitch Ratings views that the transition to the new plan is expected to be slow, and therefore the overall increase in pension costs for Korean companies in the short to medium term is not likely to be material.

However, the agency warns that the financial burden arising from the reforms would likely become more of a longer term challenge for companies that adopt the new plan.

The new plan was introduced under the Employee Retirement Security Act and supplements the existing 45-year-old severance pay scheme ("SP scheme").

The principal impediments to a wide ranging adoption of the new plan, particularly by large companies, include the insufficient level of incentives, the voluntary nature of adoption and companies' fear of an increasing financial burden from pension liabilities.

The Employee Retirement Security Act was passed by the National Assembly in December 2004 in an effort to provide a more comprehensive retirement package for South Korean workers. Previously, under the Labor Standards Law, Korean corporates were required to pay their employees a lump-sum severance pay worth at least one month of salary per year of service.

However, with the changes in Korea's demographics, the focus on retirement benefits has increased. According to the National Office of Statistics of Korea, the country became an ageing society in 2000, and is expected to be an aged society by 2018.

The government recognized that the existing SP scheme, under which Korean employees were entitled to only 5.8 months of salary as at August 2003, provides limited coverage and does not make a significant contribution to financial security in retirement.

The scheme applies only to companies with five or more employees and only to employees who have worked for at least one year at the same company.

The scheme has attracted substantial criticism as it only effectively caters for less than half of the country's total salaried employees.

Its unfunded nature, with only a small number of companies making an appropriate level of external savings, has also exacerbated the criticism.

Under the new plan, Korean companies with five or more employees can either continue with their existing SP scheme or introduce the new retirement pension plan, either in the form of a defined benefit retirement plan ("DB plan") or a defined contribution retirement plan ("DC plan"), subject to agreement between the corporate and its employees.

Either plan can be adopted between 2008 and 2010 by companies with less than five employees. The new benefits will be payable to employees who participate in the plan for 10 years or more.

Payments will commence from the age of 55 and continue for at least five years, as the National Pension Fund commences payments to retired employees from age 60.

Under the DB plan, the pension benefits which a vested employee receives after retirement are defined and determined typically based on the final salary and length of service.

Companies are required to provide the vested employee with the benefits after retirement and to invest at least 60% of its pension benefit obligation with a third-party.

Under the DC plan, companies are required to make an annual external investment contribution of at least one month's salary per employee. The key difference between the two plans is that the corporates will bear the investment risk under the DB plan, whereas they will have no such liability under the DC plan.

In order to encourage the conversion to the new plan from the SP scheme, the Korean government said it will provide both corporates and their employees with tax incentives: both the entire external investments and in-house provisions made by companies under the DB plan and the contributions made by those under the DC plan will be admitted as tax deductible business expenses.

However, these incentives do not appear to be materially different from those available to companies under the SP scheme, thereby failing to provide a meaningful incentive to adopt the new plan.

As much as the Korean government would like to encourage adoption of the new plan, Fitch expects that it will take a long time for the plan to become firmly established in the Korean business community.

Many companies fear that they will be more heavily burdened with required contributions to be reserved externally under the new plan as most have been making only in-house provisions or saving no more than a small proportion of the appropriate reserve externally under the SP scheme.

The non-compulsory nature of the new plan has also restricted awareness within the business community.

According to the Ministry of Labor of Korea, just 2,107 Korean corporates had chosen to adopt the new retirement pension plan by mid-February 2006 and about 97% of these were companies with less than 100 employees. The total number of Korean companies with five or more employees in 2004 was 495,000.

### A Long-Term Challenge

Over the longer term, companies adopting the DB plan (under which they have to bear the investment risk) will likely see the harshest impact since capital, which could otherwise be used for productive investment, may be required to fund pension benefit obligations and to support low or negative returns on the plan assets.

Another issue is the inadequacy of the accounting framework in relation to the new DB plan. In November 2005, the Korea Accounting Institute ("KAI"), the accounting standard-setting body of Korea, published its opinion on "Accounting of Retirement Pension Plan Adoption" ("the Opinion"), a guideline for pension accounting for Korean companies adopting the new plan.

Fitch observes that the Opinion is neither sufficiently detailed nor comprehensive.

For example, the defined benefit obligation to current employees is calculated under the assumption that they retire on the date of the balance sheet instead of the relevant future date and that they are paid in a lump sum instead of an annuity.

The agency is aware that KAI is currently working to produce a new Statement of Korea Accounting Standards in relation to the new plan from a mid-to long-term perspective.

# Economy in Good Shape

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The South Korean economy is an impressive performer in this era of globalization. South Korea is one of the world's top 10 economies and trading powers. Furthermore, the macroeconomic picture looks very strong:

GDP growth exceeds 5 percent, inflation stands at about 2 percent, unemployment continues to be negligible, the government's budget has been balanced or even in surplus for the last few years, the trade and current account balances are strongly positive, and the national currency appreciates steadily relative to the dollar and other currencies.

With a picture such as this, it is hard to avoid being complacent about the future.South Korea, however, cannot afford to relax. The global economy is a long-distance race, that is, a marathon and not a sprint.While South Korean workers and businesses are competitive today, there is no guarantee that other countries may not surge ahead in the future.

There are two areas of concern that require immediate attention if South Korea is to continue growing: the structure of foreign trade and the service sector.

The structure of South Korean exports needs to be watched carefully. One third of exports are accounted for by electronics products, many of which have become commodities over the last few years. Although firms such as Samsung Electronics and LG Electronics are likely to continue growing and succeeding on a global basis, it is not clear that they will be able to do so without shifting more production offshore to lower-cost locations.

Moreover, South Korea's export boom in electronics generates large imports of key components, machinery, and technology services from Japan, producing a large trade deficit with that country. Korean companies in electronics need to continue upgrading their technological capabilities so as to reduce their dependence on foreign technology and know-how.

The second most important export category is automobiles (10 percent of the total), in which Hyundai stands out as a formidable global competitor.

Unfortunately, South Korea will soon lose its comparative advantage as a location for automobile assembly to countries like China, India or Vietnam. As in electronics, the Korean automobile industry needs to intensify its effort at developing new technology and making better components.

The third most important export industry in Korea is machinery. Similarly to the other two industries, Korean firms in machinery are also dependent on foreign technology, and the country could soon lose its location comparative advantage if it does not upgrade its capabilities.

Finally, the fourth-largest export industry — chemicals — suffers from a similar problem to electronics in that it is an activity in which margins are thin and new competitors from other parts of Asia could pose a serious challenge.

All in all, South Korean manufacturing continues to be very strong on a global basis. The above considerations are meant to be early warning signals rather than indications that something is going awfully wrong. If South Korean manufacturing firms anticipate global trends, increase their productivity, and develop more of their own technology, then their future will be very bright indeed.

In contrast to manufacturing, the service sector is lagging seriously behind in terms of internationalization and global competitiveness. Samsung Life happens to be one of the largest insurance firms in the world not because it is a multinational firm (like Samsung Electronics), but because it operates very successfully in a protected domestic market.

The same is true of companies such as Korea Electric Power and KT. South Korea needs to become globally competitive in services if it is to continue on its high-growth path. The global economy is a service economy. One cannot have highly protected financial services and infrastructure industries (electricity, water, and telecommunications), with large firms comfortably enjoying windfall profits without competing on a worldwide basis.

South Korea's future appears to be very bright because of three main factors: its relatively stable and well-functioning political system, its highly educated population, and the amazing culture of hard work. It is true that South Korean politics could be less contentious and prone to scandal. But the country is —together with Japan — the most stable politically in all of East Asia.

The South Korean population is among the most highly educated in the world. The primary and secondary school system produces high-quality graduates.

Although the national examination system is biased in favor of certain subjects and ways of learning that tend to undermine creativity, Korean graduates are among the best prepared in the world in reading, science and mathematics.

The Korean university system exhibits similar advantages and disadvantages. The strong growth in labor productivity since the 1980s — ranking at the very top of the OECD at an annual compound rate of more than 4 percent — clearly demonstrates that education and the culture of hard work are helping the Korean economy grow quickly without inflationary pressures.

Finally, South Korea is making a strong effort in research and development, spending about 2.6 percent of GDP, compared to an average of 2.2 for the OECD.

Moreover, Korean companies contribute more to that effort than the government when compared to other countries. Korean residents are applying for increasing numbers of patents. Still, the country suffers from a persistent deficit in technology, the largest of any OECD country at 2.4 billion dollars.

This deficit is due to the fact that South Korean exporters of electronics, automobiles and machinery rely on foreign technology, which they must pay for.

Thus, South Korea's future economic well-being depends to a very large extent on whether the current R&D effort can be sustained and the country's dependency on foreign technology is reduced.

In sum, the South Korean economy is in very good shape. Although success in this global world of ours is never guaranteed, the country seems to be on the right path. Only a continued effort at liberalizing service industries, improving the infrastructure, and developing a national technology base will deliver sustainable growth and well-being over the long run.

Korea has come a long way since Independence. It has become a relatively advanced economy and weathered important crises in the early 1980s and in 1997. The world expects the country to continue doing well and contributing to global economic growth.