

OPINION

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The Implications of Recent US Retirement Plan Reform for Korea

The 2022 retirement plan reform by the Biden administration, which is considered the biggest change since the financial crisis, focuses on managing longevity risk management and eliminating blind spots based on confidence gained from the success of the 2006 investment management reform. The reform includes a series of measures such as mandating the disclosure of monthly pension benefits, expanding incentives for including lifelong pension plans, exempting lifelong pension providers from fiduciary responsibility, and easing the minimum withdrawal obligation, and others. All of those suggest that Korea's discussions on annuitization should go beyond the restrictions on IRP withdrawals and be more diversified. Furthermore, the reform allows hourly workers to participate in retirement plans with mandated enrollment in 401(k) plans and wide-ranging tax benefits to employers. This implies that Korea should address the current blind spots with a dual approach combining relaxed enrollment requirements and employer incentives. Another notable implication for the US reform is the importance of prior success in the investment management reform. Under the discretionary system in Korea and the US, policy measures for annuitization and elimination of blind spots may lose momentum without confidence in investment returns. In addition, instead of dealing with public pension reform on which a political consensus can hardly be obtained, the US government effectively used a series of issues—depletion of the social security trust fund, population aging, and increased old-age insecurity due to inflation—as a driving force for retirement plan reform that could better muster bipartisan support. This also has implications for how to carry out pension reform in Korea.

As widely known, the US is the country with the highest pension replacement rate (42%) in the world. Despite the institutional success of high returns leading to a high income

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replacement rate, retirement plan reform in the US is still in progress. Amidst the ongoing pension reform in the United States, we can identify the principles and directions to which the Anglo-American pension system is heading. Furthermore, the recent retirement plan reform by the Biden administration will provide significant implications for Korea, which is also following the path of the Anglo-American pension system.

1. Background of retirement plan reform

In the US, retirement plan reform—unlike the reform on the social security system—is generally carried out under bipartisan support. This was also what's observed in the recent retirement plan reform called SECURE 2.0 of 2022 by the Biden administration. That is why the stance of current reform is consistent and coherent with the previous administration's policies. As the nickname "SECURE 2.0" suggests, the Biden reform is an extended and reinforced version of the earlier "SECURE 1.0" by the Trump administration that reflected pension reform principles of the Democratic Party, then the majority in Congress.

One notable point is that the new reform contained no mention of improvement in investment return. As indicated by the high income replacement rate, DC plans have successfully overcome the relative return handicap compared to DB plan thanks to the long-refined fund-type governance structure and the 10-year experience of default options. As a result, US retirement plan reform naturally centers on addressing enrollment blind spots and managing longevity risks. Among these, longevity risk management is a common challenge faced by Anglo-American systems, such as the one in Australia and the UK. On the other hand, enrollment blind spot issues are unique concerns for countries like the US and Korea, which opted for voluntary enrollment, unlike Australia with compulsory enrollment or the UK with automatic enrollment.

The background behind the bipartisan retirement plan reform continuing under a consistent stance in the two governments can be attributed to the following reasons. Firstly, although the social security trust fund is destined for depletion like Korea's National Pension, bipartisan cooperation for reform is hardly likely for retirement plans. For that reason, the Biden government is unable to present a reform plan on the social security trust fund, a pay-as-you-go public pension scheme that will be depleted in the mid-2030s according to the fiscal estimate. Against the backdrop, the post-pandemic global inflation and the 2022 asset market

crash have accelerated the projected depletion of the social security trust fund and led to a decline in pension asset values. As a result, the savings gap has widened, and concerns about longevity risk have increased.

Second, the system for US retirement plans represented by 401(k) is a model optimized for efficient management of pension assets, but it has many weaknesses in managing longevity risks. The system encourages workers to voluntarily annuitize their lifetime income. Institutionally, it adopts a minimum intervention approach by penalizing early lump-sum withdrawals to ensure that retirement assets are not depleted for daily expenses. This policy trend still characterizes 401(k) as it opts out mandated annuitization. However, it is also true that policy consideration for longevity risk management has been strengthened since the 2010s, and it constitutes an important feature of the Biden reform.

Third, the success of US retirement plans is not widely distributed among the entire US population. According to the U.S. Department of Labor, the proportion of workers enrolled in retirement plans among all private sector workers is 52% as of 2022, which is similar to that of Korea. In addition, since enrollment in retirement plans is not mandatory but optional in the US, employees can access retirement plans only if employers provide them. As of 2022, the proportion of employees working in businesses with retirement plans amounts to 69% of all private sector workers. In other words, many employers have not yet introduced retirement plans. Even in cases where employers have implemented them, a significant number of employees (with a take-up rate of 75%) have not enrolled in the plan. It can be assumed that the government has no choice but to place its policy focus on eliminating blind spots.

This article explores the specific improvements made by the SECURE 2.0 Act to address enrollment blind spots and longevity risk management. In fact, it is worth noting that the Act includes 92 sections covering a wide range of improvements that are much broader than the two topics mentioned in this article.

2. Mandatory auto enrollment, and more tax – advantageous contribution

The most significant change related to enrollment is that retirement plans are now open to hourly employees. The reason why the enrollment rate remained at 52% is that a significant number of hourly employees (55.8% of workers aged 16 and above according to the Department of Labor in 2021) have limited access to retirement plans. The focus of the reform

was to determine the extent of part-time employment contracts to be included as eligible participants. In SECURE 1.0, the scope was expanded to include what is commonly referred to as long-term part-time employees. In other words, the previous requirement of 1,000 hours of continuous work over 12 months was relaxed to 500 to 999 hours of continuous work over 3 years. Furthermore, SECURE 2.0 further relaxed this requirement, allowing workers aged 21 and above who have worked for 500 hours or more for two consecutive years to enroll in tax-qualified retirement plans, starting from 2025. The requirement was relaxed to include relatively short-term hourly workers as well.

Second, while expanding the eligibility for hourly workers, the revised law also shifted the automatic enrollment system, introduced in 2006, from employers' voluntary adoption to mandatory implementation. In fact, such automatic enrollment can be considered a very groundbreaking change, given the US market environment that values private autonomy. However, mandatory automatic enrollment will apply only to 401(k) workers at operations newly established after 2025, and it will not affect existing retirement plans. Under automatic enrollment, employers will automatically contribute 3-10% of the employee wage to their plan account. However, employees are allowed to opt out of their plan without any disadvantages on their contributions made under automatic enrollment.

Third, the Act raised the ceiling on tax-benefit contributions by employees. Previously, contributions to retirement plans were eligible for income tax deductions, and to some plan holders, tax credits. But SECURE 2.0 expanded the additional catch-up contribution limit to \$10,000 starting from 2025 for individuals aged 50 and above, who are concerned about the widening savings gap due to global inflation. Also, the limit is adjusted upward annually in line with inflation. Additionally, SECURE 2.0 allows workers earning \$145,000 or more annually to enjoy tax benefits by making additional contributions to Roth IRA, which is something similar to Korea's Individual Savings Account (ISA).

Finally, it expanded the scope for employers to match employee contributions into student loan repayments. This measure was taken in response to the perception that Millennials and Generation Z workers are half-hearted about making contribution to their retirement plans due to the burden of student loan repayments. Moving forward, even when workers in this cohort use a portion of their salary to repay student loans, employers can consider the repayment amount as eligible for matching contributions. This enables employers to encourage those workers to build up their pension savings.

3. Aggressive incentives for employers newly adopting 401(k) plans

The measures mentioned earlier to address enrollment blind spots, such as hourly employees' plan participation and mandatory automatic enrollment, are beneficial for employees, while imposing significant burdens and costs on employers. Hence, SECURE 2.0 provides significant incentives to employers to reduce the related costs in line with the US policy environment that values private autonomy.

A case in point is the tax credit for the cost of employers who newly adopt retirement plans. The government does not provide cash directly to employers, it compensates the related cost through tax credits. Tax credits are for employer matching and operating expenses. First, in the case of operating expenses, even before SECURE 2.0, employers with 100 or fewer employees were given tax credits of the lesser of \$5,000 or 50% of plan-related expenses for the first three years starting when the plan is effective. SECURE 2.0 allows businesses with 50 or fewer employees to receive tax credits of the lesser of \$5,000 or 100% of plan-related expenses for the first three years starting from 2023. The rules remain the same for businesses with 51 to 100 employees.

Second, employers newly adopting retirement plans are subject to a tax credit of up to \$1,000 per employee for their employer contributions (matching or Roth IRA). The tax credit up to \$1,000 per employee is provided for 100% of contributions in the first two years, 75% in the third year, 50% in the fourth year, and 25% in the fifth year. For employers with 51 to 100 employees, the tax credit ceiling decreases by 2 percentage points for each employee exceeding 50. Additionally, employees earning \$100,000 or more are not eligible for the tax credit.¹⁾

4. Stronger incentives for longevity risk management

Along with addressing enrollment blind spots, longevity risk management is emphasized as another direction of the SECURE Act reform. There are three proposals that deserve attention. First, the most crucial information for workers to manage longevity risk is the estimation of their post-retirement living expenses and the amount of their post-retirement monthly income

1) For reference, Korea provides 10% of employee contributions per worker for operating expenses over the first three years when it comes to small and medium-sized enterprises. As for the tax benefits for DC contributions, employers, not employees, receive a 100% deduction for the expenses.

from their pension assets. In the US, just like in Korea, workers are provided the information about how much one would receive from social security benefits after retirement. However, that information was not available in retirement plans. This is why SECURE 1.0 introduced a system that notifies the amount of pension benefits. All plan providers are obliged to inform individual workers of their current amount of plan assets and the estimated monthly pension benefits, the amount computed by converting plan assets into a lifetime income stream. This is a kind of mandated notification function to raise awareness about pension asset accumulation and longevity risk management. This appears to be much more effective than the pension portal operated by Korea's financial authority.

Second, the qualified longevity annuity contract (QLAC) system was expanded. A QLAC is a contract that allows funds in a retirement plan to be rolled over to an annuity sold by insurers. This was introduced by a law revision in 2014. SECURE 2.0 raised the rollover limit to \$200,000 to address the growing retirement insecurity due to social security trust fund crises and global inflation. At the same time, it abolished the 25% cap for the rollovers from the total pension assets to QLAC. The expansion of the QLAC limit can be seen as a significant step in terms of the policy objective of managing longevity risk. However, from an institutional perspective, it has also spurred significant controversy. The reason is that such a change may not be in line with fiduciary responsibility from the perspective of investment returns. Secure 1.0 included a fiduciary safe harbor provision for the selection of insurers providing QLACs, unlike other investment products. It is regarded as an exemplary case showing the US government's will to strengthen lifetime income, while the market's reaction is in general critical due to the provision's neglect of fiduciary responsibility.

Lastly, required minimum distributions (RMDs) were relaxed. In the US, individuals are allowed to withdraw from their retirement plans without penalty starting from the age of 59.5, but once they reach a certain age (previously 70.5 years, now 72 years under SECURE 1.0), they are required to make mandatory minimum withdrawals (either as a lump sum or as annuity payments). From that point on, additional contributions are also not allowed. The purpose of the requirement is to prevent excessive wealth transfer between generations and to secure tax revenues. SECURE 2.0 extended the mandatory withdrawal age to 73 years from 2023 and to 75 years from 2033. Furthermore, the revised law reduced the penalty for not withdrawing RMDs timely from 50% to 25%, and further to 10% if the missed RMD is taken during the

correction window. All those changes are designed to encourage individuals to continue working and contributing to their savings, in order to manage the savings gap and longevity risk arising from the extended life expectancy.

5. New concept in liquidity policy: Introducing an Emergency Savings Account

One of the distinctive features in SECURE 2.0 is the relaxed rule on lump-sum withdrawals. Like other countries, the US has restricted early withdrawals of pension assets, and this has been the basic policy stance. The US imposed penalty on early withdrawals, but there was an emergency withdrawal system as in Korea that allows penalty-free withdrawals under certain conditions such as a house purchase. Instead, the US has maintained a policy stance of promoting pension loans that allow households to meet their temporary liquidity demand using their pension assets. Pension loans are widely used in the US, in contrast to Korea.

However, the policy shift towards tolerating early withdrawals in SECURE 2.0 is somewhat related to the increased liquidity pressure on households due to the pandemic and inflation, among other factors. The core of the tolerance policy lies not in indiscriminately allowing for early withdrawals, but in the introduction of a new system called Emergency Savings Accounts (ESAs). The ESA is a retirement plan-linked savings account that allows pensioners to withdraw their assets relatively freely. Employers are not obliged to open the account, but can contribute within 3% of the wage of DC pensioners. Employers can make tax-qualified matching contributions. However, contributions are after-tax contributions, not pre-tax, so workers receive tax benefits. The upper limit of the account balance is capped at \$2,500. Employees can make free withdrawals up to four times. Market experts view this policy as having the potential to reduce early retirement withdrawals. It is a counterintuitive policy as it provides tax benefits for emergency savings rather than pension assets for the sake of protecting retirement assets. Moreover, the revised law introduced a relaxation policy that allows penalty-free withdrawals up to \$1,000 per year from plan accounts for urgent financial needs, for example, childbirth.

Implications for Korea

Although Korea's pension system is heading towards the Anglo-American model, there are significant differences and historical gaps compared to the US. Given the rapidly declining birth

rate, aging population, the worsening environment for retirement income, there is a need for compressed development of Korea's pension system. The US reform mentioned above has the following implications.

First, it is worth paying attention to policy priorities. The US first carried out investment management reform aiming to improve returns, followed by enrollment and annuitization reforms. The order may not mean anything in countries like Australia with mandatory enrollment. However, order matters in the US and Korea with discretionary enrollment. This is because confidence in high returns is a precondition for convincing policies such as blind spot elimination and annuitization. Korea has a severance pay system that provides returns at the rate of wage increase every year, without the retirement plan system. Hence, the prerequisite for the widespread adoption of retirement plans is a competitive advantage in returns through investment management reform. With low returns, it is hard to make a convincing case of policies such as blind spot elimination and annuitization. In this regard, default options are important for retirement plans to make a leap forward. Fortunately, it is encouraging to find out the 6-month return to reach more than double the past return. Still, it is necessary to take seriously the fact that the share of principal-guaranteed products in default options is higher than the share of those products in DC plans and IRP before the introduction of default options. At this critical juncture, what's important is market discipline that restores confidence in investment returns through superb management capability. Policy authorities need to strengthen monitoring of the system to overcome some of the handicaps of Korean default options.

Second, a comprehensive approach is needed for managing longevity risk. The US annuitization policy goes beyond product-levels (such as target-dated funds and lifetime annuities), to be more comprehensive such as employee notification systems, emergency savings programs, etc. In particular, the mandatory notification of pension benefits can be viewed as an important nudge to induce employees to be better aware of their financial conditions and accumulate more assets for retirement income. If the investment return with the expected monthly pension benefit is provided in a pension provider's management notice, instead of the portal site of financial authorities, this is expected to change employees' perception on pension management and annuitization. Along with this, there should be product innovation such as incorporating pension products into TDFs, or creating TDF glide paths that maintain asset allocation even after retirement. It is also worth considering the

feasibility and method of applying emergency savings accounts, one of the counterintuitive policy measures to protect plan assets, given Korea's condition where pensioners withdraw most of their pension assets during their job transition process.

Lastly, the US retirement plan reform provides implications for reform priorities. Instead of reform on the social security trust fund on which a political consensus can hardly be obtained, the Biden administration prioritized retirement plan reform that could achieve bipartisan agreement more easily. Although the US social security trust fund is a pay-as-you-go system and its depletion has less impact as compared to Korea's National Pension Fund. However, its depletion is expected to occur in the mid-2030s, earlier than in Korea. The US, which is no less urgent than Korea, capitalized on the depletion of the public pension and the resulting anxiety in old-age income as a driving force for reforming the retirement plans, not the public pension. This is probably because retirement plan reform contributes more to stabilizing old-age income, no less than social security trust funds do. As the replacement rate of the Korean public pension has declined persistently, retirement plans are expected to play an increasing role in stabilizing old-age income. Therefore, it is not reasonable to view retirement plan reform as less important than public pension reform. Retirement plan reform has a large political and economic marginal effect. It is advised that the priority of reforms should be decided taking into account both the effectiveness and feasibility in a strategic manner.