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INSIGHT

Private Pension Schemes and the Need to Revise the Management Fee

Private pension schemes are needed as population aging accelerates and it becomes harder to fully rely on public pension systems. Photo credit: Korea Institute of Finance.

It is necessary to redesign private pension management fee schemes so companies have incentives to compete and develop better products.

Introduction

In the Republic of Korea, market trust in private pensions and retirement pensions is weakening amid poor investment returns and fixed fees that are charged regardless of investment outcomes. This is raising concerns over loss of participants and a market slump. The current fee scheme is advantageous to management companies, without benefits for long-term participants, and there are cases of over-charging fees as well. To address this and promote the market for private pensions, it is necessary to revise the fee scheme.

Analysis

As population aging accelerates and it becomes harder to fully rely on public pension to prepare for post-retirement living, it is important to further promote private pension schemes. Backed by government measures in this direction, contributions to private pensions and retirement pensions have grown steadily, each to 321.9 trillion won and 149.8 trillion won as of June 2017.

For private pension, the share of pensions unqualified for tax benefits is relatively higher, and among financial institutions that sell private pensions, insurers represented the highest share of 74%. Pensions qualified for tax benefits allow for tax deduction, and they can be subscribed in three forms?trust, insurance, or fund. Pensions unqualified for tax benefits do not meet requirements for tax deduction, but instead subject to tax exemption at the time of receiving pension benefits, and include immediate annuity, long-term savings insurance, and life-time pension.

Table 1: Contributions to Private Pension

(Unit: tril. won)

	2013	2014	2015	2016	June 2017
Pension savings qualified for tax benefits	90	101	109	118	123
Pension savings un-qualified for tax benefits	155	169	183	192	199

Source: Financial Supervisory Service

As for retirement pensions, 53.5% of all employed workers subscribed to retirement pension as of June 2016, and both the participation rate and contribution amount have steadily increased, led by banks' DB (defined benefit) pensions.

Table 2: Contributions to Retirement Pension

(Unit: %)

	2012	2013	2014	2015	2016	June 2017
DB	73.8	72	70.5	68.3	67.8	65.7
DC	18.8	20.9	22.4	23.1	23.9	25.2
IRP	7.5	8.0	7.0	8.6	9.0	9.1

Source: Financial Supervisory Service

Average annual returns of private pension and retirement pension for the 2012-2016 period was 3.28% and 3.1%, respectively, lower than National Pension Service. The relatively poor investment return can be explained by the lack of portfolio diversity due to participants' preference for safe assets and underdeveloped advisory service, and also because a lot of private pensions were sold with guaranteed principal and interests (74.3% of private pension and 89.7% of retirement pension as of 2016).

Table 3: Investment Return of Public and Private Pensions

(Unit: %)

	2012	2013	2014	2015	2016	Average
Private Pension	4.4	3.7	3.3	2.8	2.2	3.28
Retirement Pension	4.8	3.7	3.2	2.2	1.6	3.1
National Pension Service	7.0	4.2	5.3	4.6	4.8	5.18

Source: FSS, based on investment return prior to subtracting management fees

With poor investment return and management fees paid at a fixed rate relative to the amount of contributions?regardless of asset management outcomes?there are concerns over the lack of trust in private pensions and potential loss of participants and market slump. Management fees vary by management companies, and they are annual average of 1.05~1.47% for private pensions (as of 2017, for pensions held five years or longer), and 0.38~0.47% for retirement pensions (as of 2016). Thus, pension management companies are likely to neglect efforts to boost investment returns, and instead focus on selling more products. They also have little incentive to carefully rebalance portfolio according to changing market conditions, or develop better pension products. Indeed quite a few private pensions and retirement pensions are in names only, and in fact identical to other funds. As private pension market loses trust, only 54% of participants are holding pension products for 10 years or longer, and the participation rate in private pensions is steadily declining from 15.0% in 2012 to 13.2% in 2015.

Insights

The current management fee scheme for private pensions is geared toward financial companies' profits, without benefits for long-term participants, and in some cases, fees are over-charged. For instance, IRP market is growing as maximum amount of tax deduction is raised and more people become eligible. However, IRP is similar to private pensions, and participants are charged management fees applicable to retirement pension in pursuant to the Employee Retirement Benefit Security Act even when a participant makes an online subscription without receiving advisory service (e.g. product recommendation or explanation). Going forward, to promote market for private pensions, it is necessary to redesign management fee scheme so that management companies have incentives to compete harder and develop better products.

References

Korea Institute of Finance website.

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