

INSIGHT

# Promoting the Default Option in Private Pension Systems



Target date funds automatically adjust the share and composition of shares and bonds as investors approach retirement age. Photo credit: ADB.

*In the Republic of Korea, efforts are underway to adopt one of the most broadly used pension default options.*

## Introduction

In the Republic of Korea, legislative efforts are underway to allow a default option in management of personal pensions and retirement pensions, and domestic asset management companies began to offer Target Date Fund, one of the most broadly used default options globally. Going forward, asset management companies need to rigorously analyze pension subscribers' demographic data?life table, retirement rate, assets, cash needs after retirement?as well as macroeconomic data such as inflation and wage growth to design and offer Target Date Funds better tailored to the domestic market environment.

# Analysis

In the Republic of Korea, the Financial Services Commission (FSC) and the Ministry of Employment and Labor are working on introducing a default option for personal pension and retirement pension, for more efficient management of the funds. A default option means managing pension fund in a pre-designated way unless the subscriber requests otherwise. In November 2016, the FSC made a prior announcement of enacting the Personal Pension Act, which would allow fully entrusted pension products, in addition to the currently approved products—insurance, trusts, funds—to broaden a range of options for consumers. With fully entrusted pension products, a financial company, on behalf of the consumer, manages the pension funds according to a portfolio regarded suitable for the consumer's investment profile and preferences.

As for retirement pension, the Ministry of Employment and Labor submitted a bill to revise the Worker's Retirement Benefit Guarantee Act, which proposes to allow financial companies to manage pension funds in a pre-designated manner if a subscriber does not indicate how to manage them, laying a legal ground to adopt a default option. To apply the default option under the current retirement pension scheme, it would be necessary to revise provisions of the said Act that are related to the legal nature of contract (e.g. entrusted investment vs. investment intermediation), responsibility of employers and employees over investment loss, waiver of a duty of explanation for pension management companies, and a possibility of retroactive application of the default option.

Once the default option is introduced, the supervisory authority would map out requirements for default option suitable for long-term, risk-diversified investment; then, a financial company designs pension products with a default option accordingly; then the supervisory authority reviews and approves qualified options that meet the criteria. In the US, the default option was introduced with the 2006 Pension Protection Act, and the Ministry of Labor designated Target Date Fund, Balanced Fund, Managed Account, and Capital Preservation Fund as Qualified Default Investment Alternatives (QDIA). Among these, Target Date Fund represents over 80% of all QDIA, which automatically adjusts the share of stocks and bonds, as well as their specific compositions, according to the target date of retirement. In the UK, specific product categories have not been designated as QDIA, but the Pension Regulator issued a guideline to set clear long-term strategic goals, and consider stability of investment strategies and asset allocation, adequate level of costs, and risk management ability. In Japan, the goal of default option is defined as "securing profits against losses that could arise from inflation and other adverse economic events in a long term," and specific supervision and regulation are left to the Ministry of Health, Labor and Welfare.

# Insights

In the Republic of Korea, asset management companies have begun to offer Target Date Funds in partnership with overseas companies. The currently offered products mostly replicate foreign companies' frames, by incorporating their funds into investment portfolio.

If domestic asset companies are to use Target Date Fund as a default option, they need to rigorously

analyze various data. These include dynamic demographic data such as life table, retirement rate, assets, cash flows needed after retirement, risk preference of pension subscribers, to estimate a gliding path of the share of stocks in funds. Particularly, medical bills are apt to rise sharply after retirement, and this might affect the amount of needed cash flows depending on different medical care systems of countries. Other macroeconomic data should be analyzed as well to design tailored Target Date Funds.

In the US, since introduced in the early 1990s, Target Date Funds have continued to evolve to find an optimal structure. Specifically, the share of active funds has fallen over time, while that of passive funds increased; and the share of stocks rose slightly. Management companies have sought various investment strategies including index funds, smart beta funds, and hybrid funds, and more recently, they are seeking to include alternative investment like REITs in Target Date Funds. Other considerations would include deciding the level of home bias in fund portfolio, hedging against FX risks, and setting an adequate level of service fees.

## Resources

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