

OPINION

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Default Options in Retirement Pensions and Improvement in the Return on Plan Assets

Korea has introduced default options with the aim of raising post-retirement income through a higher return on plan assets. To achieve that goal, it should implement measures including the compulsory introduction of default options and approval for qualified products to ensure the establishment of the default option scheme and effective competition. On top of that, Korea also needs to alleviate negative factors for the long-term rate of return, such as the permission of principal-protected products and employees' direct selection of default options. Such negative factors could solidify plan members' lack of interest and a selection bias regarding principal-guaranteed products. This suggests that unlike advanced countries' default option system, Korea's scheme should focus more on providing training programs tailored for the life cycle of plan members. Meanwhile, TDF risk rating assessment should also be adjusted reasonably to ensure that Generation MZ (encompassing millennials and Generation Z) can hold TDFs as default options for a long term until retirement, regardless of their investment propensity. In addition, the transfer of default options should be improved to enable plan members to keep holding their portfolios even when they change jobs. Furthermore, the criteria for dynamic eligibility evaluation should be established to facilitate competition for a better return on default options. Building upon such criteria, plan providers should engage in business conduct. Also necessary is to set up a separate default option disclosure system similar to the one adopted by Australia to bolster market discipline by plan members.

Korea has introduced default options in retirement pensions. The default option scheme planned for introduction in 2014 has now been in place, which has boosted market

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expectations. However, there are also concerns about whether the goal of achieving post-retirement income security through a higher return on pension assets could be attained. Such concerns may be attributable to unique aspects of Korea's default option scheme. During the process of implementing the scheme, Korea should utilize promising aspects of default options to facilitate the market and relieve relevant concerns, aiming for meeting the purpose of regulatory reform to raise post-retirement income through the increase in returns on plan assets.¹⁾ Against this backdrop, this article evaluates key elements of Korea's default option scheme to figure out the possibility of attaining the policy objective to increase the rate of return, and explores further improvements.

Negatives to the rate of return: Permission of principal-protected products and direct selection of representative products

Notably, Korea's default option scheme is characterized by the permission of principal-protected products and employees' direct selection of default options (pre-designation of a representative plan). In terms of the return on retirement pensions, it is also worth considering contract-type governance, mandatory introduction and approval for qualified default options. First of all, the controversial permission of principal-guaranteed products evidently harms the return on plan assets. If Korea adopts a fund-type retirement pension scheme based on strict fiduciary duty, instead of the contract-type scheme underpinned by the duty of care, it would not have been possible for employees to select a principal-protected product. This is because long-term investment in principal-protected products is highly likely to conflict with the fiduciary duty. In the documents prepared by the US Congress, principal-guaranteed products are not qualified for default options. Furthermore, the US Department of Labor specified that "default options should be designed to meet the goal of boosting the long-term value of plan assets," when introducing the default option scheme. Accordingly, the US has decided to allow plan members to choose principal-guaranteed products only during the 120 days for investment decision (investment instruction period), while prohibiting the new establishment of the Stable Value Fund that was voluntarily operated by the market before 2006 since the enforcement of

1) The amendment to the Act on the Guarantee of Employees' Retirement Benefits approved in January 2021 specifies that the goal of introducing default options is to raise post-retirement income through the increase in the rate of return. The amendment points out employees' lack of interest and plan assets managed mainly through principal-guaranteed products as the cause for lower returns.

the relevant law. As indicated by such cases, Korea needs to come up with regulatory measures to relieve or offset the negative effect of principal-protected products on the return on plan assets. As a type of product subject to approval for default options, the Korean government has accepted a model portfolio combining a fund with a principal-protected product. This may be part of its effort to mitigate a behavioral bias of selecting a single product without principal loss as a default option.

Another feature of Korea's default option scheme is that employees are permitted to designate a representative product as their default option. Contrary to its initial intention (mandatory transfer of authority for investment instructions when no specific instruction is given), Korea's scheme has accepted the do-it-yourself governance structure of existing DC plans. The problem lies in the impact of such a structure on the rate of return. Although it has both advantages and drawbacks, the negative effect on the return on plan assets prevails as a whole. Among the two benefits of the do-it-yourself structure, one is an exemption for plan providers. Korea has decided to allow plan members to select a representative default option as a way of resolving the issue of liabilities for investment loss. Thus, plan providers exempted from investment loss-related liability would actively compete to offer more innovative default options, which helps raise the return on plan assets. Another benefit is the effect of economies of scale. As mentioned by the government, if the selection of a representative default option is coupled with the approval system for qualified default options (approving a certain number of products to induce effective competition), it could boost the effect of asset allocation through economies of scale and at the same time, facilitate innovative competition for achieving a better rate of return. Notwithstanding such benefits, negative effects of the designation of default options such as plan members' lack of interest and passive management of plan assets are likely to outweigh the two benefits. Such effects seem inevitable because Korea has introduced default options without the transfer of authority for investment instructions. The two positives of selecting a representative default option could offset the adverse effects only if additional measures are implemented to avoid the chronic lack of interest among plan members. Currently, the best alternative policy is to offer training programs and adjust how risk ratings of target date funds (TDFs) are determined.

Positives to the rate of return: Mandatory introduction and approval for eligible default options

Unlike the two features mentioned above, the mandatory introduction and approval for default options seem to have a positive impact on the establishment of the default option scheme and improve the rate of return. The compulsory introduction of default options could facilitate competition for a better return on plan assets through quantitative expansion of default options. As of June 2021, a total of 6.06 million plan members are subject to default options, representing around 64% of the entire retirement pension holders (9.5 million members in total, including IRP holders). Also, the default option scheme applies to 40% of the entire regular employees (15 million members) in Korea. Default options would be applicable to 42% of the aggregate retirement pension assets (KRW 124 trillion) and 300,000 out of the entire 400,000 business entities subject to the retirement pension scheme. The volume of default options is large enough to bring a seismic change to the pension market, probably acting as market pressure for promoting competition for improving the rate of return.

In addition, the approval system for eligible default options is expected to play a critical role in facilitating default options by reducing information asymmetries and building up the trust of plan members. Notably, Korea has implemented the retirement pension governance structure where plan providers rarely take on the level of a fiduciary duty imposed by advanced countries. Under the structure, the government-guaranteed eligibility approval system could offer great benefits. The system can be divided into prior eligibility evaluation where the government guarantees qualification of default options to some extent to bolster the confidence of plan members and dynamic eligibility evaluation where only a default option that makes a greater contribution to post-retirement income is approved through performance evaluation. Korea has defined the two evaluation schemes by law, which could play a significant role in raising confidence in default options and boosting the rate of return.

To further improve its default option scheme, Korea should reduce worrying factors such as principal-protected products and selection of a representative product, while taking advantage of the elements for boosting the return on plan assets including mandatory introduction and prior/ex-post eligibility approval systems. The tasks to be performed for the objective are as follows.

The greater importance of training programs for plan members

Like the current DC plans, Korea's default option scheme allows plan members to choose a representative product and offers principal-protected products as default options. Under the scheme, it is more important to provide training programs to ensure that employees actively engage in the management of their plan assets. This is the opposite to advanced countries' system where a pension trustee should give investment instructions if plan members are not involved in the management of pension assets. Under the system of advanced countries, the introduction of default options could undermine the importance of training for plan members. It is worth noting that if training can spark the interest in investment instructions, negatives to the return on plan assets—principal-guaranteed products and a selection bias arising from choosing a representative product—could be relieved through market discipline. This necessitates supportive measures to practically improve training programs for plan members.

The training designed for plan members should put more emphasis on the principles and fundamentals of plan asset investment than on the concept of DC plans or default options, which could raise their interest in investment instructions. Investment principles include the long-term investment principle focusing more on long-term asset allocation for retirement savings than on stock trading, in addition to general principles for managing plan assets according to a required rate of return derived from a shortfall in post-retirement income. Plan members should be informed of how these principles are reflected in available default options. At a time when default options are specified in pension rules, such training must be provided for plan members who have to select default options.

Reasonable assessment of TDF risk ratings

Target date funds (TDFs) are structured to automatically reduce the weight of risky assets with the lapse of time. They are a type of pension fund for long-term asset holding which plan members decide to choose to benefit from automatic asset allocation. In this respect, what matters is how TDF risk ratings are assessed. As TDFs are designed for age-appropriate dynamic asset allocation (glidepath), a different approach should be taken regarding the assessment of TDF risk ratings. Risk ratings should be determined, under the assumption that the entire glidepath, instead of the weight of risky assets at a specific time (risk threshold),

represents asset allocation. In this respect, the method based on risk bearing capacity is used as part of such assessment. For instance, early-stage risky assets account for more than 80% of the aggregate assets in TDF 2050. But when risk ratings are assessed, it is necessary to consider that plan members' target maturity is 30 years or longer and derisking is automatically implemented during that period. This suggests it would be reasonable to view a glidepath as an asset allocation system as a whole, rather than focusing on the investment mix in a glidepath classified by level or segment. For this reason, the US and Australia categorize TDFs as mid-risk balanced funds. Korea's supervisory authorities have also labeled TDFs as a mid-risk balanced fund, given that a weight of risky assets declines from up to 80% in the initial stage to 40% at expiration.

As indicated by the default option-related Q&A document released by the Korean government, however, it has assigned separate ratings by vintage, not following the aforementioned TDF risk rating classification. For instance, TDF 2025 falls into the mid-risk fund category while TDF 2040 is classified as a high-risk fund. This causes difficulties in TDF management. TDFs are assigned with different risk ratings by vintage and thus, plan members can select only a vintage that matches with their investment propensity. According to the TDF investment advisory track, a plan member aged 30 could not select a TDF with a higher risk rating (e.g. TDF 2055) relative to his or her investment propensity (e.g. preference for a mid-risk fund). If a plan member wants to hold TDF 2055 for a long term until retirement, only the mid-risk funds such as TDF 2025 and TDF 2030 are available options. And the plan member should subscribe to another TDF upon expiration. This can be mistakenly understood as a system that encourages repeatedly making several short-term investments in plan assets. Such a restriction could undermine the positive role of TDFs as a pension plan as well as their advantages and shorten the investment horizon of plan members. Considering that it seems impracticable to assess risk ratings by the weight of risky assets in the early-stage glidepath, it is worth noting that risk rating classification based on TDFs' attributes is the global standard. If TDF default options fall under the mid-risk fund category, regardless of vintages, the plan assets funded by those who have selected TDFs would be automatically invested in vintage-specific TDFs by age. If a plan member pre-designates a TDF from a selection of principal-protected products, TDFs and balanced portfolios, a plan provider would give instructions for the automatic management of TDF 2050 by taking into account the age of members (e.g. the age of 30). If this

happens, negative effects arising from the selection of a representative default option would be alleviated to a considerable extent. Notably, whether the pre-designation is subject to the investment solicitation regulation under the Act on the Protection of Financial Consumers could spark controversy. Hopefully, Korea could implement the investment solicitation regulation in a flexible and reasonable manner after considering product attributes, given that it has also been put in place under advanced countries' default option scheme subject to a strict fiduciary duty.

Infrastructure improvements for long-term holding of TDFs regardless of job changes

In a case where a plan member holds a certain TDF at expiration, the classification of TDFs into a mid-risk fund category would be given greater validity. As the length of service of Korea's employees is six years, DC plan assets should be transferred to IRPs whenever they change jobs. As stipulated in the Act on the Guarantee of Employees' Retirement Benefits (the "Act"), default options placed in DC plan accounts (e.g. a TDF) could be transferred in a physical form to IRPs, rather than being exchanged into cash upon the request of employees. In the market, however, it seems difficult to transfer default options in a physical form due to computer systems and other issues. Although the average length of service for employees of the US is seven years, not quite different from that of Korean employees, the US enables a free transfer of default options in a physical form and thus, plan members can continue to manage their plan assets for a long term through a specific TDF even after they change jobs.

Meanwhile, it would not be until a transfer can be freely conducted in a physical form that the adjustment of risk rating classification for TDFs becomes more convincing. If the difficulty of transferring default options in a physical form persists, plan members need to purchase a TDF when they switch jobs. In this case, assigning different risk ratings by TDF vintage could be a more convincing method, albeit not meeting the global standard. Considering the attributes of plan assets, a trustee should induce plan members to engage in the long-term investment of plan assets to maximize their benefits. Accordingly, plan providers should improve the infrastructure for transferring default options in a physical form, whereas the government needs to consider a shift in the TDF risk rating classification towards long-term investment.

Facilitating competition for a higher rate of return through approval for eligibility

The well-functioning eligibility approval system could help establish an effective competition structure in the default option market, thereby boosting the return on plan assets. Under the Act, the eligibility approval system includes both the prior examination of qualified products and the follow-up verification of dynamic eligibility through monitoring of the return on default options. The prior approval system should be geared toward boosting the rate of return through the market structure suitable for effective competition and economies of scale. Approving more than enough products triggers excessive competition and diseconomies of scale whereas too few qualified products give rise to oligopoly and internal diseconomy, undermining innovativeness of default options and efforts to improve the rate of return. As 43 plan providers analyzed can get approval for seven products, respectively, the eligibility assessment for underlying assets such as deposits, insurance products, funds would serve as a yardstick for economies of scale, which plays a key role in determining the competition structure of the default option market. In the US, TDFs represent 97% of default options and the top 27 TDF management firms take up a 91.7% share of the TDF market. The market share of the top 5 firms is 79%,²⁾ which represents oligopoly rather than effective competition. In this regard, the US Congress has commenced an investigation into how the TDF market structure and business conduct of TDF firms have affected the welfare of plan members last year.

Additionally, the dynamic eligibility assessment is of importance to continuously boost returns through effective competition. The amendment to the Act has established the legal basis for conducting a dynamic assessment every three years. Among a wide range of assessment criteria, the assessment procedures would focus on whether the return on plan assets contribute to increasing post-retirement income through real value enhancement and whether it is in the best interests of plan members to select underlying assets incorporating default options. With this respect, Korea needs to study Australia's dynamic eligibility assessment system and its impact on the pension market to promptly establish the criteria for dynamic eligibility evaluation. Building upon such criteria, plan providers should design and operate default options in the TDF market formation stage, with a focus on a sustainable improvement of the return on plan assets.

2) Morningstar, 2022, 2022 Target-Date Strategy Landscape; Vanguard, 2022, How America Saves 2022.

Bolstering market discipline by plan members through a comparison-based disclosure

Default options are the ones that meet stricter requirements for government approval, compared to general financial products. Such requirements include information to be provided by plan providers for plan members who have to select a default option, and relevant quantitative indicators such as the rate of return should be disclosed on a regular basis. Despite such regulatory measures to alleviate information asymmetry, the current disclosure system needs to be improved by facilitating a comparison-based disclosure. For this purpose, default options selected by plan members, as well as performance data of each plan provider should be compared for disclosure. It is more appropriate for Korea to consider Australia's default option scheme rather than the US system. Australia has set up a separate disclosure scheme for default options and has disclosed relevant information through a comparison of individual default options. Based on well-performing market discipline by plan members, Australia has kept a balance between market discipline and regulatory framework, which is well evidenced by its disapproval of 13 out of 80 default options through the dynamic eligibility assessment in 2021. Given regulatory loopholes such as the permission of principal-protected products, the desirable approach for Korea is to reform the disclosure system for a more effective market discipline.