

OPINION

Nam, Chaewoo

Pre-approval for Qualified Default Options and Role of Financial Institutions

Korea's default option pre-designation has been introduced as a selective default option system to the existing retirement pension scheme. It can be understood as a system similar to the representative product designation that requires retirement pension plan providers to offer low-cost, high-efficiency products to support DC plan or IRP holders in their product selection. The Ministry of Employment and Labor pre-approves up to ten representative products for each provider. After employees pre-designate a product suitable for their risk appetite, the products can function as an opt-out default option. Given that default options can be managed for a long term without any investment instruction, financial institutions or providers of default option products should take seriously their fiduciary duty to act in the best interest of employees. The fiduciary duty needs to be considered from the first stage of the default option scheme including product design and qualified default option pre-approval.

In an analysis of 259 qualified products approved by the Ministry of Employment and Labor, most of them seem to fulfill requirements including low fees and stable returns. It is notable that various products including the principal-protected type take the form of a fund of funds (FoF), not a single deposit or fund. In the process of building a default option portfolio with a mix of subfunds, it is necessary to underscore the importance of risk diversification, a prerequisite for plan asset management. What is also needed is to provide default options fit for individual risk appetites based on the suitability principle. It becomes commonplace globally to use TDFs in default option composition but TDFs are inaccurate and inconvenient to establish an FoF that deals with a non-variable level of risk. A target risk fund (TRF), one type of balanced fund (BF), is more appropriate for the FoF composition. As for TDFs, it is advisable to use a single TDF that represents a target date corresponding to individual risk appetites. Recently, FoFs consisting of TDFs increasingly serve as a typical default option, which raises serious concerns.

* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

* Ph.D., Research Fellow, Fund & Pension Department, Tel: 82-2-3771-0827, E-mail: zeuss@kcmi.re.kr

The default option scheme represents both heavy liabilities and great opportunities for financial institutions. In terms of risks and returns, the capability of designing and providing qualified products can serve as the most critical competitive edge for financial institutions in Korea's pension market that lacks healthy competition. This suggests that the key to the success of default options lies in building the trust of employees in long-term investment.

Understanding of Korea's default option scheme

Default options have been introduced to Korea's retirement pension scheme. More precisely, the default option concept has been offered for the defined contribution plan (DC plan) and the Individual Retirement pension (IRP) under the name of the default option scheme as a tool for managing plan assets. The default option is an institutional framework that should have been adopted when DC plans and IRPs, being criticized for their systemic limitations, were first used for plan asset management. But the scheme took effect in Korea in June 2022 after prolonged discussions and a tortuous process. The pre-approval for qualified default options¹⁾ was completed by the Ministry of Employment and Labor in the second half of 2022. It would be the end of the first half of 2023 when employers (companies) stipulate the introduction of default options in retirement pension rules and employees select one of them.

Korea's default option scheme (K-Default Option), introduced through a difficult process, widely differs from its counterparts adopted by other countries in terms of implementation procedures and portfolio composition. Accordingly, a proper understanding and extra efforts of various market participants including employers and employees are needed to ensure that the K-Default Option takes hold and is actively used as a tool for managing retirement pension plans. This requires retirement pension plan providers (financial institutions)—key stakeholders in the Korean retirement pension scheme with contract-based governance—to take on a greater role and responsibility. In countries with an advanced retirement pension scheme, the

1) As a similar concept, the 401k plans of the US offer the Qualified Default Investment Alternative (QDIA), which, however, widely differs from qualified products under Korea's default option scheme in terms of purpose and composition. The 401k's QDIA seeks risk diversification in long-term investments as a precondition for immunity from a default option investment loss. Accordingly, it hardly includes principal-protected products but mainly consists of investment-linked products with diversified risks.

default option serves as a plan asset managing tool for an overwhelming majority of DC plan holders, a phenomenon that can hardly be explained only by individuals' indifference to how to manage plan assets. A fundamental factor behind the default option's popularity is that employees place great trust in default options as an investment tool. In other words, the default option is widely accepted by employees as the low-cost, high-efficiency product designed by financial experts for long-term investment. The K-Default Option has a contradictory structure that emphasizes personal responsibility by requiring employees to make an additional choice. Against this backdrop, it should be noted that it is up to plan providers or financial institutions to build long-term trust in their investment strategies and facilitate the default option scheme.

In this light, the K-Default Option should be understood as a scheme in line with the representative product designation system planned by the supervisory authority, rather than a typical default option scheme.²⁾ In terms of long-term management of plan assets, the default option is a mechanism designed to compensate for individuals' lack of asset management capabilities. A typical default option scheme entirely makes an investment decision on behalf of employees unless specific instructions are given, while the K-Default Option aims to facilitate reasonable plan asset management by narrowing down individuals' choices to publicly managed qualified products. The K-Default Option exactly meets the purpose and structure of the previous representative product designation system, except for the fact that the provision and selection of products are forced by law. The representative product designation presupposes healthy competition between financial institutions. Accordingly, plan providers should design and provide default options as a key tool for gaining a competitive advantage over other institutions in the pension market. Going beyond competition between financial institutions, however, it pertains to a fiduciary duty imposed upon a person who exercises professional judgment in the management of another party's assets. In this respect, this article examines the current approval process for qualified default options and explores how financial institutions serving as retirement pension providers should respond to the process.

2) In 2015, the Financial Supervisory Service introduced the representative product designation system to support DC plan members in their reasonable selection of pension plans. Under the system, each retirement pension plan provider builds a representative portfolio (a mix of pension plans) in advance and registers the portfolio with the supervisory authority while DC plan members choose the portfolio as their pension plan. As it is not mandatory, the system could not elicit voluntary participation of plan providers and ended up being abolished.

Pre-approval for qualified default options

Under the revised Employee Retirement Benefit Security Act (the “Act”), a plan provider shall provide an employer with multiple default options pre-approved by the Ministry of Employment and Labor; the employer shall stipulate the introduction of default options in its retirement pension rules; and an employee shall select one of the default options pursuant to the revised rules. As the first step of this procedure, a plan provider should single out seven to ten default options by risk appetite and gain approval from the supervisory authority.³⁾ An employer should choose at least one default option for each risk appetite from a selection of as many as ten default options and add the selection result to the retirement pension rules. Such revision to pension rules necessitates consent from the employee representative. Out of the products specified in the pension rules, an employee who holds a DC plan or IRP should designate a default option in advance which will automatically invest the employee’s plan assets in a pre-designated product if he/she gives no specific instruction.⁴⁾

The Ministry of Employment and Labor’s Deliberation Committee conducted two rounds of evaluation and approved a total of 259 out of 318 products submitted by 39 plan providers as of the end of 2022.⁵⁾ With the high initial dropout rate, the practical guideline for qualified default options was delivered to the market, which contributed to positive improvements such as the reduction of the average expense ratio by more than 30%. What is notable during the pre-approval process is that all types of default options including ultralow-risk, principal-protected products were offered in the form of a fund of funds (FoF) consisting of less than three funds, rather than a single fund. The Ministry of Employment and Labor initially accepted the FoF as a type of qualified default option in an effort to achieve risk diversification underscored by plan asset management.

The K-Default Option defines the FoF as a portfolio. In financial theory, portfolio composition

3) Korea’s default option scheme classifies risk appetites into ultralow-risk (principal-protected type), low-risk, medium-risk and high-risk categories, except for ultrahigh-risk products. And it requires plan providers to build and present two or three portfolios (or a single fund) with one ultralow-risk product included for each risk appetite as default options.

4) This means that default options are practically opted in, not opted out. In addition, employees who select DC plans or IRPs can designate a default option as their pension plan when giving investment instructions. For this reason, the K-Default Option should be understood as an opt-in default option system.

5) Out of a total of 318 products, 259 gained final approval, representing an approval rate of around 81%. But 55 out of 220 products submitted for the first evaluation round failed to qualify, representing a high dropout rate of 25% (Ministry of Employment and Labor, December 21, 2022, the government and financial institutions pool their wisdom and capabilities to guarantee employees’ retirement security, press release).

is designed only to seek impossible-to-diversify market risks by eliminating unsystematic risks through a mix of individual investment components. However, there is hardly any logical foundation for how risk diversification is implemented during the FoF composition. Notably, the K-Default Option necessitates a default option that corresponds to an employee's risk appetite pursuant to the suitability principle of the Financial Investment Services and Capital Markets Act. Under this structure, plan providers should exert more effort to establish reasonable and meaningful FoFs for each risk appetite by using existing retirement pension plans.

Financial institutions' role in facilitating default options

Among qualified products, the ultralow-risk type refers to principal-protected products that sparked controversies during their adoption process. As for principal-protected products, financial institutions can provide a wide range of products ranging from time deposits to equity-linked bonds (ELBs) or repurchase agreements (RPs) offered by securities firms and guaranteed interest contracts (GICs) of insurance firms. But most products submitted for this round of qualified default option approval fall into the ultralow-risk type that consists of less than three time deposits handled by commercial banks. For instance, three deposit options—each offering a respective interest rate—are selected and mixed in the ratio of 4:3:3 to calculate a weighted average for the portfolio interest rate. In Korea's financial environment where the depositor protection system is in place and bank failures rarely occur, ultralow-risk portfolios consisting of deposits hardly function as a proper tool for risk diversification.

Principal-protected products are risk-free assets that entail no market risk and whether such products are selected for plan asset management is entirely determined by the agreed rate of interest offered by financial institutions. In the absence of any market risk, credit risk, or counterparty risk, an employee can make an investment decision only based on interest rates. However, under the current default option scheme with no instructions given by employees, the ultralow-risk type should integrate a certain proportion of deposits offering rates lower than the best rate, which may come into conflict with the fiduciary duty defined as an obligation to act in the best interest of clients. This problem stems from the integration of principal-protected products into the default option scheme based on risk diversification of investment assets.

The risk diversification-related issue could be more prominent in portfolios comprised of low-, medium- and high-risk products, most of which are linked to investment. In the pre-approval for qualified default options, most portfolios submitted by financial institutions are a mix of target date funds (TDFs), instead of balanced funds (BFs). Low-risk products combine deposits and TDFs, while high-risk products represent a mix of various TDFs with different maturities provided by multiple asset managers. A given low-risk product can be made up of 80% of deposits and 20% of TDFs. This product may be considered the low-risk type due to a lower proportion of TDFs but it could suffer losses during market falls such as a financial crisis, depending on the target dates of TDFs. Considering that individuals with a low risk appetite are more sensitive to the maximum drawdown than volatility in overall returns, the possibility of principal loss could be unacceptable. In another case, Product A is classified as a low-risk product due to its 20% of TDF 2040, while Product B is considered a medium-risk type for its 80% of TDF 2025. If normally managed, at this point, TDF 2025 would show a risk-return pattern similar to that of bonds. After all, Product A may exceed the acceptable risk limit of an investor with a medium risk appetite and Product B is likely to fail to meet long-term returns expected by the investor. Taken together, this can have negative effects on building the long-term trust of employees regarding investment in representative products. It seems practically impossible for the supervisory authority or the competent committee to examine all of these issues and approve the best default option with high efficiency in the qualified product approval process. This would be solely undertaken by plan providers who design and provide financial instruments.

These difficulties stem from the fact that a TDF, the purpose-based asset allocation fund, is inappropriate for the FoF composition for each risk appetite. After all, a TDF is not suitable for establishing FoFs to deal with certain risk appetites such as low-, medium- and high-level risks. FoFs submitted for the qualified product pre-approval are found to deal with risk appetites demanded by default options by taking into account different risk levels by target date.⁶⁾ For instance, a high-risk product focuses on TDF 2045 while a medium-risk product combines TDF 2025 and TDF 2045. Considering a TDF glide path that is almost a black box and portfolio composition, however, such TDF composition is particularly inaccurate and inconvenient.

6) A TDF is designed to rebalance risk levels, depending on a target date-specific glide path. Considering this, the TDF 2025 that draws near to the target date is classified as a low-risk fund such as bonds while the TDF 2050 that is many years away from the target date falls into the high-risk fund category.

It is noteworthy that TDF risk levels are dynamically rebalanced every year according to an independent glide path, which makes TDFs all the more unsuitable for default options serving as long-term investment tools. Although TDFs are regarded as a mainstream product type for default options in other countries, the application of TDFs is limited to a single TDF invested for the long term. This is because a single TDF internalizes spatial and temporal dispersion effects needed for the management of plan assets.

A BF is a useful tool for building an FoF portfolio targeting a certain risk level by risk appetite. It is also called a target risk fund (TRF) as a TRF is designed to maintain a certain risk level by using a wide range of assets including stocks and bonds. Notably, Korea's default option scheme requires a tailored default option by risk appetite to be provided based on the investor suitability principle. In this case, it is more efficient and reasonable to establish an FoF by using a mix of TRFs that specify risk levels. Another problem with a TDF-based FoF is that dynamic risk adjustment, the most critical feature of TDFs, cannot be reflected effectively. In the K-Default Option, a TDF should be provided as a default option for a single fund according to a target date selected by an individual's risk appetite.

Conclusion and implications

A qualified default investment alternative (QDIA) of the US has been structured to allow companies to gain immunity from a default option loss. Companies responsible for setting up a default option should make the best decision only for the interest of employees, for which a QDIA has been provided as a minimum requirement. In Korea, however, both financial institutions designing default options and companies implementing default options by revising pension rules are fully immune from liability for investment loss. Korea's employees are not given any default option by default but need to select one. For this reason, employees should take sole liability for any loss. In this regard, the K-Default Option differs from the US system where a QDIA should be pre-approved by the supervisory authority for companies to gain immunity. In the case of Korea, it is worth considering that a majority of employees lack the capability of managing plan assets and the pension market is dominated by financial institutions providing pension plans. Given such a negative assessment of Korea's retirement pension scheme, Korea seems to have adopted the qualified product pre-approval system as a minimum investor protection.

In this sense, the pre-approval for default options should focus on minimum requirements. It should take the form of negative screening aiming to eliminate in advance bad products that fall short of minimum requirements, rather than positive screening designed to select good products through a pre-approval process to guarantee high returns. This round of the pre-approval process applied disapproval criteria such as products sold by affiliates, excessive sales commissions and poor performance relative to remuneration. The supervisory authority's pre-approval for a qualified product should not be interpreted as a certification for the product's returns and efficiency. It is necessary to clearly define pre-approval as a way of filtering out unqualified products. To facilitate default options, the supervisory authority should strive to reinforce the disclosure system to ensure that default option performance for each financial institution can be compared and evaluated with transparency. As for competing products provided by private financial institutions, the government's pre-approval should not be mistaken for the guarantee of their supremacy.

The selection of good products should be conducted by retirement pension providers, not the supervisory authority. It is worth noting that providing high-quality products in terms of returns and stability is not only the fiduciary duty to be strictly fulfilled by plan providers but also a critical factor to gain a competitive advantage in the retirement pension market.