Latest Developments on Default Investment Option for Korea DC Retirement Plans

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The amendment of Employee Retirement Benefit Security Act requiring all DC plan sponsors to implement "Default Option" of investment is now effective from July 2022. Companies sponsoring DC plan will need to prepare an action plan.

What is "Default Option" in DC plan?

Under defined contribution plan, the default investment option is the fund or strategy that employees DC plan assets are automatically invested when the employee opts not to choose their own investment option.

The amendment of Employee Retirement Benefit Security Act in December 2021 required all DC plans to state the default options on their plan document, effectively from July 2022. However, due to the delay in development of detailed guidelines from Ministry of Employment & Labor, there are no investment options available for default options until November 2022. Thus whilst the legislation is now effective, the government has allowed a 1-year implementation deadline up to 1 July 2023.

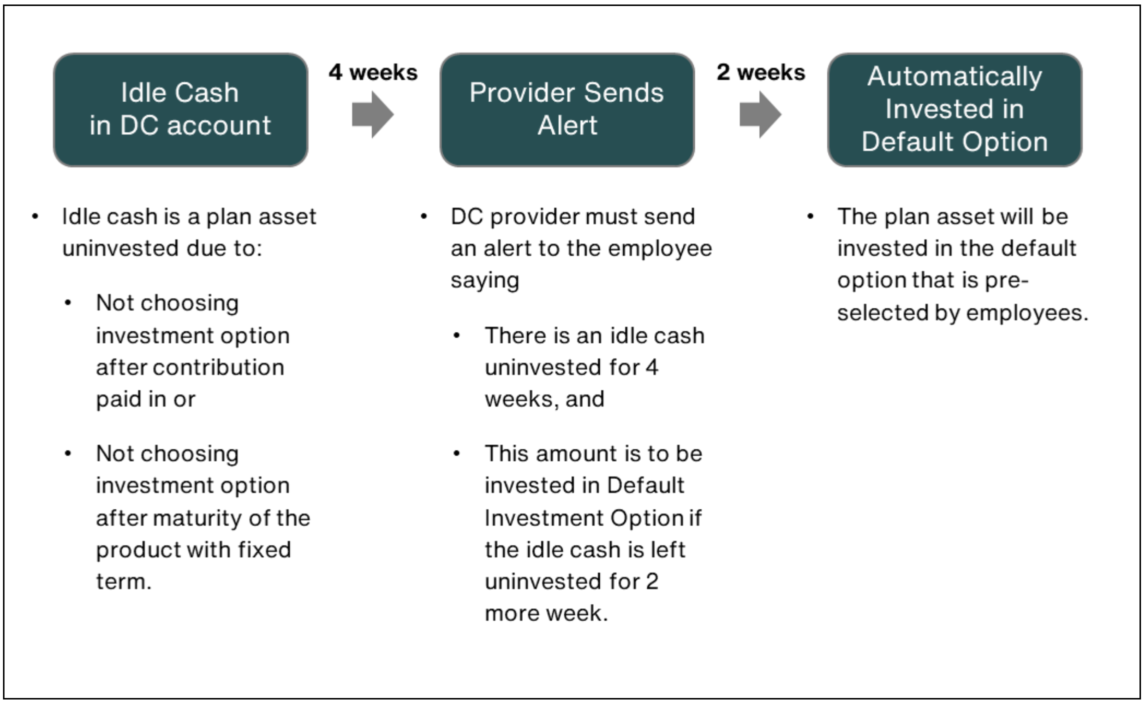
How is "Default Option" in DC plan triggered?

The default options are triggered when there is no investment options chosen by the employees.

According to Korean regulation, the time required for Default Option to be triggered is 6 weeks. When there is an idle cash in the DC account for 4 weeks, the DC service provider must send the employee an alert saying that his plan asset is currently uninvested. If the plan assets remain uninvested for 2 more weeks after the alert, the plan assets are automatically invested in the "default option" investment that is pre-selected by the employees.

When this legislative change was announced in December 2021, the original reaction from the market was this this change will have a limited implication. The chance of the default option being triggered is very low, as all employees are supposed to make the investment selection at the time of enrollment, and this investment selections are automatically applied to the contribution paid into the plan asset. Many experts in the market viewed this legislative changes as no more than administration burden.

However, Ministry of Employment & Labor decided this legislative change more meaningful to everyone by banning the automatic renewal of the products with fixed term maturity such as time deposit. All principal-interest guaranteed (PIG) products, which currently take up of more than 75% of entire plan asset in Korea, is now subject to the potential trigger of default option investments if the employee does not renew them upon its maturity. The automatic renewal of the PIG products is not allowed from the products reaching maturity after July 2023.



Process of Selection of Default Option

The law specifically states the types of investment products that can be considered as the "default option" and requires the DC service providers to obtain the approval from the Ministry of Employment & Labor on whether the investment options can be offered to the client as the default option. More detailed regulatory requirements were developed as:

- Ministry of Employment & Labor does not believe the employers sponsoring DC plan possess the expertise to select the default investment options on their own. They want the DC service providers to be involved in the selection process.
- However, Ministry of Employment & Labor is also concerned that DC service providers may dodge their responsibilities by offering their clients with hundreds of different options and ask them to select from. They want the DC service providers to be more responsible when offering the default options to their clients.
- There is also another regulatory requirement from "Financial Consumer Protection Act", requiring all financial institutions to conduct the risk tolerance assessment of the individual customers – individual DC participants for DC, before selling the financial products. The sales of the investment products exceeding the risk tolerance level of the individual is not allowed according to this regulation.

The process of selection of the default option was shaped as followed:

1. There will be 4 levels of employees' individual risk tolerance level – High, Medium, Low, Minimal. The DC service provider must conduct the risk tolerance assessment for individual employees.
2. DC service providers will be allowed to offer up to 7 investment options to cover the 4 levels of risk tolerance – one option for the minimal risk and 2 options for the other three levels. Ministry plans to expand the number of options to 10 in near future.

3. The employer sponsoring a DC plan is to select the default options from the options offered by the DC service provider.
    A. The DC service provider must offer at least one option for each risk level, but the plan sponsor does not necessarily have to select at least one option for each risk level. (For extreme case, the plan sponsor can only allow the minimal risk product for the default option).
    B. In case of the multiple DC providers, each DC providers must offer the default options.
4. The selected default options must be stated on the plan document. The revised plan document is subject to the employee consent.
5. Each employee will be preselecting their own default option. Employees are not allowed to select the default option with risk level higher than the employees' own risk tolerance level.
6. When the default option investment is triggered, the idle cash will be invested in the default option preselected by each employee.

As mentioned earlier, up to 7 investment options will be allowed for each DC service providers. These options must be approved by the Ministry of Employment & Labor before being offered to their clients. Since the Ministry has announced that the approval will be granted by end of October, the earliest timing for companies to make an action will be in November 2022.

Default Option Implementation Process

1	Default Option Selection (by employer)	• DC service providers to submit the available default option portfolio. • Employer to choose the default option portfolio per provider.
2	Employee Consent	• Amend the plan document with the default option stated. • Deliver the employee communication session and ask employees for consent.
3	Risk Tolerance Assessment & Individual Default Option Selection	• DC service providers to conduct the risk tolerance assessment for individual employees and receive the individual default option selection.

Available Investment Options

The law specifies the types of investment products that can be considered as the “default option” as below:

① Product that guarantees the principal and fixed rate of interest. (PIG)

② Product with predetermined target date and the allocation automatically adjusted toward higher portion in lower-risk products as the target date is approached. (TDFs)

③ Product that invests in different types of asset classes with allocation adjusted and rebalanced based on the changes in values of the underlying asset and the financial environment, targeting the higher long-term investment. (Balanced Funds)

④ Short-term investment that minimizes the risk of shortfall and targets the stable short-term return. (MMF)

⑤ Product that invests in infrastructure, public financing plan or business sponsored by central or provisional government. (SOC Funds)

⑥ Other options that are determined in the presidential decree.

DC service providers are supposed to prepare a product or construct a portfolio that are to be offered to their client as default option, and their line-up of default option should be able to cover all four level of risk tolerance level. Few notes and trends Aon can share are:

Minimal Risk Portfolio

The guideline from Ministry of Employment & Labor on minimal risk portfolio was that they shall be Principal-Interest Guaranteed (PIG) products that can be provided to the client consistently without a limitation of volume. Such requirement excludes the ELB/DLB (due to limitation of supplies) and time deposit issued by mutual savings bank (as the sales volumes are limited to KRW 50M per issuer).

Insurers are providing the GICs they issued themselves. Providers other than insurers are offering portfolio consisting of time deposits issued by multiple banks.

Target Date Funds

Target Date Funds (TDFs) are widely used to cover the default options for higher risk tolerance levels.

- This is not because TDFs are ideal for the situation of default option – rather this is because TDFs are the products that are most clearly defined as the available products for default option in the law. (Please reference the numbers to the list of the available types of the products listed above).
  - ① PIGs and ④ MMFs are considered as the option for minimal risk portfolio.
  - Because assessing the risk amount of ⑤ SOC funds are difficult, utilizing them to cover different level of risk and meet the requirement from Ministry is difficult.
  - ③ Balance Funds have too wide definition. Many providers believe the definition of ③ is not clear enough to risk chance of disapproval from the Ministry of Employment & Labor.
  - Since ② TDFs are clearly defined in the law, they are viewed as the “readily available options.

- Ministry of Employment & Labor has already announced that they will only allow up to 7 options in the beginning. 7 options indicates that the provider can only offer two line-ups as default option portfolios. Given the short timeline for preparation, providers do not wish to face the situation where they have no approved default options available in November, which will make not only have less time to work with their clients to implement default option, but also may also lead to critical damage on their reputation. The construction of default option line-up with TDFs is a safety fallback for providers.
- While TDFs are widely used options for default option worldwide, it is not a sensible option in Korea. Because of the classification of default option portfolio by risk level, the investors cannot stick to the original glidepath of the TDF product.

Example of an employee investing in TDF via default option

- An employee is currently investing in TDF 2040, medium risk default option.
- As per nature of TDF, the asset allocation will shift accordingly to its predetermined glidepath, hence the risk level of the product will also change over time.
- This means that TDF 2040 will no longer qualify for the default option product as "medium risk" in few years' times. The provider will replace their medium risk default option with products with corresponding risk level such as TDF 2045.
- The continuous update of TDF with newer version will make its glidepath no longer valid, and it will rather look similar to the balanced fund with multi asset class.
- TDFs tend to have higher fees than normal balanced fund due to the cost of development and maintenance of its glidepath. If we are not planning to take the advantage of its glidepath, there is no need of investing TDF.

<u>Auto-Renewal of PIG</u>

- The auto-renewal of PIG will no longer be allowed from July 2023. Until now, when the 1-year time deposit matures, it was automatically renewed with the same product or a similar product in the renewable product pool. However, the balance will now be converted to idle cash when the product reaches its maturity and will be subject to default option trigger starting from July 2023.
- Some providers view default option as the method of auto-renewal of PIG. If the employee chooses the "minimal risk portfolio" as the default option, the idle cash will be invested in PIG which somewhat resembles current PIG auto-renewal.

<u>Different Risk Levels within Same Class</u>

- The default option portfolios labelled with the same risk level do not necessarily mean that their risk levels are the same.
  - The risk level of a portfolio is determined by taking the weighted average of the fund risk grade and applying the ranges.
  - The fund risk grades are determined by the issuers of the products. There can be large variations in risk even within the same risk grades.

- Based on the initial line-ups of the default option portfolios, the differences in risk level are already apparent between the providers. Monitoring of the default option portfolio will be critical – especially when you are using multiple DC providers.

Promotion Opportunities

- There are providers who believe this is an opportunity to promote their expertise in investment. These providers are trying to build the reputation as the market leader in terms of DC investment by making early strike in the initial stage of the market by launching the new investment products.
- Mirae Asset Securities have formed an internal advisory group within the company. They have launched a multi-asset fund that is advised by this advisory group.
- Korea Investment & Securities have developed a multi-asset fund benchmarking the investment allocation of MySuper – the default option of the Australian pension plan, Superannuation.

Wait & See Strategy

- While there are few providers seeing the introduction of default option as an opportunity, most of the major providers in the market are taking the "wait & see" strategy.
- Two largest insurers – Samsung Life Insurance and Kyobo Life Insurance, have submitted a single default option line-up consisting mainly of balanced funds. They will likely monitor the development of the market and plan for new default option line-ups after watching how the market develops.
- Most of the banks have launched two line-ups – one consisting balanced funds, one consisting TDFs.

How Aon can Help

"Default option" is a new concept in Korea, and the original intention of the regulatory change was somewhat shifted as the detailed regulations were developed. Given this is an initial stage of the market, the providers are likely to drive the market towards a direction that is the easiest for their administration and can bring out the most sales opportunities.

Since there are only limited choices of default option investment available by provider, the involvement of Aon supporting the plan sponsor with making the selection may not seem to be necessary. Given your default option line-up is to cover all four risk levels, you will be provided with a single choice or a choice between two. Even if you cannot select one from the two, our advice will simply be – choose the option that is not TDF.

The "selection" of the default option product may be an urgent issue for now. However, the market is currently at the very initial stage, and many providers are expected to expand their line-ups. (Ministry has announced that they will allow 10 options after all). Also, the risk level of each default options offered by each provider have large variations even between the portfolios labelled with same risk grade. Aon can provide a detailed monitoring and review of the default option portfolios, not only reference to the market, but against other default options provided in the market will be critical.

Employees' selection behavior is another key item for monitoring. Based on Aon's annual DC study[1], employees' financial behaviors are most related with who their providers are. The selection of the default option may also be related to who their providers are. In extreme case, the provider may have all employees sign up for the minimal risk default option to reduce their administrative burden, or coach them to score higher risk tolerance level for assessment in order to have them making more aggressive investment.

Another potential consideration is that this is a good opportunity to review the provider arrangement and make a potential change. If you are using multiple DC providers, each provider will be offering their own default option line-up constructed by different approaches made separately from each other. This may be a good chance to review the appropriateness and efficiency of the current provider arrangement and explore potentially changes to the provider arrangements such as reducing the number of providers and/or replacing the provider with new one that is better fit for your firm.

The introduction of the default option may be an increased administrative burden for the provider. However, we are also seeing the change as an increased responsibility on plan sponsor – as we are stating the default investment options on the plan document after all. Aon believes that it is critical for plan sponsors to take control of retirement plan; therefore, we want to emphasize that the introduction and the monitoring of the default option investment of DC plan is a critical step not only for the short-term compliance, but for the long-term sustainable management of DC plan.

[1] Aon Korea conducts annual study on the investment performances and employee behaviors related to DC plans called AON DIPS

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