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Fiduciary Considerations in Using Model Portfolios

Providing Retirement Income Features to Help Participants Achieve a Secure Retirement

A White Paper

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Key Takeaways

1. Sponsors of defined contribution plans can help their participants cope with challenges they face in both saving for and living in retirement by providing model portfolios that offer personalization and include guaranteed lifetime income contracts, such as fixed annuities.

2. Model portfolios with fixed annuities may be included in a plan's designated investment alternatives and may also serve as a plan's qualified default investment alternative.

3. In this paper, the term "model portfolio" refers to a diversified group of investment options that are managed to provide an expected return with a corresponding amount of risk. Model portfolios that are created for a specific plan are referred to as a "custom model portfolio." These may be constructed solely from a plan's designated investment alternatives or from other investments selected by the portfolio manager in addition to or in lieu of the plan's designated alternatives.

4. A diversified portfolio that is unitized, includes investments pre-selected by an investment manager and is generally available to plans on their recordkeeping platform, such as a target date fund, is sometimes called an "off-the-shelf" or commercially available product. In this paper we will generically refer to these types of investments as "non-custom model portfolios."

5. Consultants are able to provide a value-added service to the plan sponsors with which they work by designing custom model portfolios. A custom model portfolio can offer several benefits: leveraging the fiduciary process undertaken in selecting the options for the plan menu, which can be used in the custom portfolio; ensuring that the investments are of good quality and reasonably priced; and better tailoring the asset allocation and glide paths to the demographics of the sponsor's workforce.

6. Recent legislation provides for a fiduciary safe harbor for selecting and monitoring insurance companies that provide annuities and makes the process of selecting guaranteed lifetime income contracts for custom portfolios simpler and less concerning for plan fiduciaries.

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Introduction

Employees need to make decisions during their working years about accumulating money for retirement and managing that money. However, only about 25% believe that they can competently make those decisions.[1] While auto-enrollment and target-date funds have lessened the decision-making burden on defined contribution plan participants during the accumulation years, they still face a number of challenges in retirement. These challenges include:

- Determining the level of income they will need in retirement to cover essential items, such as housing, food, utilities and medical expenses, as well as discretionary items, such as travel.

- Not knowing their life expectancy in order to gauge how long their retirement savings must last or how much they can withdraw from their retirement savings on a periodic basis. In other words, participants generally are at risk as to whether their retirement income will be enough to cover their living expenses and will last for their lifetimes.

- Whether they are adequately protected from market downturns and interest rate risk leading up to and living in retirement.

- Whether they will have sufficient financial knowledge and cognitive capacity to manage their investments and any draw down strategies providing non-guaranteed income as they reach advanced ages.

In recent years, plan sponsors have begun to understand and address the needs of their participants for help with retirement preparedness and having secure retirement income.[2] (The term "plan sponsor" is used in this paper to refer to the plan fiduciary who makes decisions about the investments and services that a plan offers to participants.) As a result, plan sponsors and the consultants they work with have become more willing to consider the inclusion of lifetime income as a plan feature. (As used in this paper, lifetime income refers to a source of payments that provides secure income for the life of a participant or the participant and his or her spouse. The source of secure, predicable and sustainable income that is guaranteed for life may only be provided through an insured product, such as an annuity or other form of insured income product.)

Until recently, plan sponsors may have felt constrained in offering a retirement income feature in their plans because of possible fiduciary risk in selecting an insurance company to provide the insured product. This likely stemmed from the insolvency of several large insurers in the 1990s (the most notable being Executive Life). The concern has been that, if an insurer is unable to meet its obligations while participants accumulate their retirement savings and, perhaps more importantly, if the insurer is unable to meet its lifetime income payment obligations when participants retire, the plan sponsor's decision to offer that company's retirement income product could be viewed as a fiduciary breach.

The enactment of the SECURE Act in 2019 reduced much of the fiduciary risk through the adoption of an amendment to the Employee Retirement Income Security Act (ERISA).[3] This amendment created a fiduciary safe harbor for the selection of the insurer.[4] The new law also included other provisions that have the effect of supporting lifetime income guarantees in retirement plans.[5]

However, even if a plan sponsor chooses to include guaranteed retirement income products in its plan, participants will still need to decide to invest a portion of their account in the guaranteed option. In this case, participants may not have the knowledge to decide how to effectively allocate their assets among the different mutual funds and insurance products on the plan menu. There are several approaches a plan sponsor might take, working with its consultant, to help participants with that decision. One is to offer a professionally managed custom model portfolio as an investment option that includes a retirement accumulation and lifetime income feature. A second is to offer a non-custom model portfolio that could include diversified equity and fixed income options, along with an option that provides the opportunity for lifetime retirement income. Either of

these could serve as the plan's qualified default investment alternative or QDIA.[6] An advantage of using a QDIA that includes a lifetime income feature is reflected in studies showing that when participants are defaulted into a QDIA, they tend not to elect to move their accounts to other alternatives.[7] This indicates that if a participant is defaulted into a QDIA with a lifetime income feature, they will be assured of having the opportunity for lifetime income when they retire. Guidance issued by the Department of Labor (DOL) makes it clear that inclusion of a guaranteed lifetime income feature in a QDIA is permissible.[8]

The next section of this paper discusses the need for lifetime income. This is followed by a discussion of QDIAs and how lifetime income can be incorporated into them and then by an analysis of the fiduciary issues for the decision to include a lifetime income feature in a plan.

The Need for Lifetime Income

In the typical 401(k) or 403(b) plan, participants are responsible for funding a significant portion of their retirement savings and for deciding how their savings are invested during their working years.

With respect to the investment of their savings, the adoption of ERISA in 1974 formalized the concept of participants directing the investment of their own accounts in defined contribution plans. The statute included Section 404(c), which was based on the assumption that participants had the knowledge necessary to construct their own portfolios from the options available in the plan. In 1992, the DOL adopted a regulation under Section 404(c) that provided detailed guidance on the implementation of the section. The regulation requires disclosures to participants and imposes requirements for the range of investments that the plan sponsor needs to make available.[9] The assumption nevertheless remains that the participants have the ability to make use of those investments to accomplish three key objectives:[10]

- To "materially affect the potential return" on their accounts;
- To "achieve a portfolio with aggregate risk and return characteristics…appropriate for the participant"; and
- To "diversify the investment [of the account] so as to minimize the risk of large losses."

The current popularity of target date funds (TDFs), which automatically adjust the asset allocation in participant accounts, may indicate that many participants do not adequately understand investment concepts. These concepts include, for example, the need for prudently allocating among different types of investments in order to appropriately manage their own accounts and the need to adjust the allocation among different classes of investment as they get closer to retirement age to reduce volatility and investment risk. This may also indicate that many participants lack the investment education, experience and skill needed to achieve the objectives laid out in the 404(c) regulation.

It should be noted that while mutual fund TDFs or other non-custom model portfolios that operate as a TDF can be very helpful to participants, a custom model portfolio may provide a better alternative by leveraging the fiduciary process already used in selecting a plan's designated investment alternatives and also controlling the investments that a plan sponsor offers to participants; and by tailoring the portfolio to the demographics of the sponsor's workforce. And while the process for creating such a customized model portfolio, especially to be used as a QDIA, may seem daunting, much of the necessary information needed to tailor the portfolio to the workforce can be obtained from a plan's recordkeeper and potentially from participants the longer they remain in the plan.

The participant dilemma in managing the investment of their own accounts is compounded by the complexity of the decisions that participants must make at retirement: what to do with the money they have accumulated…which, depending on plan provisions, they may withdraw from the plan as a lump sum, make periodic withdrawals to provide retirement

income, or transfer the money to another retirement account by way of a rollover. Many participants may not be prepared to make optimal lifetime income decisions because they may not understand a number of key issues, including the following[11]:

- How long they are likely to live and, thus, how long their retirement lump sum needs to last.
- How to withdraw the lump sum as periodic income, *i.e.*, how much they can spend each month in order for their retirement savings to last for their lifetimes.
- How to invest the money in retirement, including the impact that market downturns may have on their savings.

These factors play a critical role in determining whether a participant will have sufficient and sustainable income in retirement. They also play a significant role in emphasizing the importance of making lifetime income investments available in a plan so that participants are able to build a source of income in the plan that will serve them in retirement. Providing participants with appropriate plan investments, including access to lifetime income vehicles, delivered through professional custom model portfolios and coupled with effective education and income modeling tools can help address these factors. As an added benefit, the inclusion of an annuity in a plan's custom model portfolio could serve as part of the fixed income allocation (in lieu of other options) that provides a stable and fixed return.

The need for lifetime income affects participants in both 401(k) and 403(b) plans, but with regard to guaranteed lifetime income, the historical development of the two types of plans has been somewhat different. While 403(b) plans have historically been funded with annuities, these plans have been able to offer mutual fund investments since 1974. To the extent participants elect to invest in mutual funds, the issue of lifetime income becomes significant in 403(b) plans as well as in 401(k) plans. Also, while public education 403(b) plans are not subject to ERISA and its fiduciary requirements, the 403(b) plans for private schools and many charitable institution plans are subject to ERISA's requirements; and plans in public education are often subject to state laws that impose duties mirroring those in ERISA. Since the guidance related to the fiduciary requirements of ERISA is more highly developed and applicable state laws are often very similar, the focus of this paper is on the legal requirements under ERISA.

Qualified Default Investment Alternatives

The QDIA Concept

As noted in the prior section, ERISA Section 404(c)(1) provides fiduciary protections where participants exercise control over their accounts (that is, where they direct the investment of the money in their accounts). This provision says that, when participants do exercise such control, they are deemed to be fiduciaries for that purpose, and the plan sponsor is not liable for losses that may result from the participant decisions. But this provision assumes that participants will be making their own investment decisions, which is not always the case. In the absence of participant direction, the plan sponsor is required to make the fiduciary decision on how to invest the accounts of these "defaulting participants." Prior to the early 2000s, this often meant that the account was invested in a money market fund or other secure investments. While these investments were not likely to lose value, they provided relatively little in the way of investment earnings.

To encourage the prudent investment of the accounts of defaulting participants when participants fail to make their own investment decisions, another subsection was added to Section 404(c) in 2006, to provide a fiduciary safe harbor for a plan's qualified default investment alternative (a QDIA).[12] Section 404(c)(5) says that when the accounts of defaulting participants are invested in an alternative that meets the requirements of DOL regulations and notices are provided to the affected participants, the participants are deemed to have exercised control over the investment of their accounts and the fiduciaries are relieved of liability for that decision (so long

at the investment chosen to be the QDIA is prudently selected and monitored).

The DOL regulation provides for three types of QDIA investments, and specifically excludes money market and similar alternatives.[13] The three types are:

- An investment fund product or model portfolio that is based on participant age, target retirement date or life expectancy and employs a glide path concept, that is, essentially a target date fund;
- An investment fund product or model portfolio that is designed to provide long-term appreciation and capital preservation, *i.e.*, a balanced fund; or
- An investment management service that a fiduciary manages using a plan's core investment options that employ a target date glidepath.[14]

To summarize, a QDIA must be a target date fund or portfolio, a balanced fund or portfolio, or a managed account that uses the plan's core options. The first two of these alternatives may include investment alternatives that are not included within a plan's core fund offerings. They also do not need to be commercially available products, such as registered mutual funds, but instead may be customized model portfolios for a specific plan. As a result, for all three types of QDIAs, the portfolios may be individually managed by a discretionary investment manager that takes into account the specific needs of the plan workforce.[15]

Inclusion of a Lifetime Income Feature

Though the descriptions of the permissible QDIAs in the regulation do not specifically reference a lifetime income or annuity feature, the DOL has issued guidance indicating that inclusion of such a feature does not preclude the fund or portfolio from qualifying as a QDIA. First, the QDIA regulation provides:

> *An investment fund product or model portfolio that otherwise meets the requirements of this section shall not fail to constitute a product or portfolio for purposes of paragraph (e)(4)(i) or (ii) of this section solely because the product or portfolio is offered through variable annuity or similar contracts….without regard to whether such contracts or funds provide annuity purchase rights, investment guarantees, death benefit guarantees or other features ancillary to the investment fund product or model portfolio.*[16]

In other guidance, the DOL has indicated that it would be permissible to include an unallocated deferred annuity in a QDIA as the fixed income investment component of the portfolio, saying this "would not cause the [portfolio] to fail to meet the requirements of paragraph (e)(4)(i) of the QDIA regulation."[17] This guidance was issued concurrently with a Notice released by the IRS that provided a special rule enabling plans to offer TDFs that include deferred annuities among their assets, "even if some of the TDFs within the series are available only to older participants."[18] In the Notice, the IRS acknowledged that each TDF would be used as a plan's QDIA, and referenced the DOL guidance indicating this was permissible.

Thus, selecting an investment that includes an annuity or other lifetime income feature as a plan's QDIA would be permissible so long as the investment meets the requirements of the QDIA regulation.[19] Properly structured, an annuity may be surrendered without charge during the first 90 days after a participant is defaulted into the QDIA as required by the DOL regulation.[20] In general, it also has the added advantage of providing a guaranteed increase in value during the accumulation phase.

Creation of a Customized QDIA

Over the past decade, more participants have embraced professionally managed investment alternatives – typically target date funds, managed accounts or custom model portfolios – rather than taking a more active role in managing on their own the allocation to the various investments made available under the plan. In this paper, the term "TDF" is only used to refer to registered target date mutual funds or

collective investment trust funds, both of which are typically structured as a "fund of funds." The term is not used to refer to target date-like asset allocation custom model portfolios and managed accounts designed with customized allocations and glidepaths.) These professionally managed custom alternatives take into account at least one aspect of a participant's personal situation, that is, their progression toward retirement. Many of the non-custom target date funds currently on the market offer a thoughtfully designed glide path that modifies the asset allocation of the portfolio, and therefore the volatility of the participant's account over time. However, they are, by definition, generic. That is, they are designed based on assumptions made by the fund manager and are not tailored to the specific needs of a plan sponsor's workforce and clearly are not designed to match the needs of any particular individual in that work force.

In addition, TDFs may be limited to, or use only a significant majority of, proprietary funds of the fund or portfolio manager. This factor has two potential drawbacks. First, from the manager's perspective, it makes it difficult to remove an underperforming investment that is included in the fund because of the potential "sell" signal this would send to the marketplace. Second, it puts plan sponsors at something of a disadvantage. This disadvantage is because the investment funds that comprise the TDFs are usually not the plan's core options, which are prudently selected and monitored by the plan fiduciaries. In fact, if the funds held within the TDF were individually monitored by the plan sponsor, some, or perhaps even many, would not satisfy the criteria to be included in the plan's lineup.

Thus, in monitoring and potentially removing and replacing TDFs offered in the plan, plan sponsors should consider whether to look "under the hood", that is, to delve into the investment quality of the underlying investments. For example, if a TDF is underperforming its benchmark, it is likely that the cause is the underperformance of one or more of the underlying mutual funds. Since plan sponsors could be charged with understanding why their investment are underperforming in order to monitor those investments, including TDFs, it makes sense to analyze that underperformance to determine whether to remove the entire suite of TDFs because the underlying investments are underperforming and the plan sponsor is concerned that they may not perform well in the future.

The shortcomings associated with the generic nature of TDFs, along with improved technology and reduced costs, has led to the next evolution for helping participants accumulate adequate retirement savings through prudent investing. This next step is individualized professional advice through asset allocation programs such as target date custom model portfolios or managed account services, including those that utilize the plan's designated investment alternatives. (While these investment alternatives are sometimes referred to as DIAs, they are referred to in this paper as a plan's core investment options or core options to avoid confusion with deferred income annuities.). In developing custom model portfolios, plan sponsors are able to leverage their efforts of prudently selecting and monitoring the plan's core options or are able to delegate discretionary authority to a portfolio manager to serve as an investment manager of the custom portfolios. When selecting an investment manager who qualifies under ERISA Section 3(38), plan sponsors are able to shift to the investment manager the fiduciary duty for decisions about which investments to use in the custom model portfolios, and how much to allocate to each investment (so that investments other than the core options may also be included).[21]

When custom model portfolios are included in a plan, these portfolios may also serve as a plan's QDIA. However, the inclusion of custom model portfolios and the use of those portfolios as a plan's QDIA addresses only one part of helping participants achieve sustainable retirement savings. That is, it only addresses the "accumulation" phase of retirement savings. "Accumulation" refers to period of participation when employees are working, and saving and investing in a plan. The next phase, commonly called the "decumulation" phase, starts when an employee retires, no longer draws a paycheck and begins living off personal savings, Social Security benefits, defined benefit pension benefits (which are increasingly rare), and the defined contribution retirement account built up while working. In effect, once retired, those amounts become the former employee's paycheck, and the lifetime income provided by Social Security and defined benefit pension plans (if available to the employee) may not

provide sufficient replacement income for the individual to maintain their pre-retirement lifestyle.

Addressing Retirement Income

Legislators and regulators, professionals and service providers involved in the business of retirement plans, employers, and employees appear to be realizing the need for sustainable lifetime income in retirement. There are a number of ways to address this need, but the one that offers the greatest security with the least risk is an investment option that includes the protection of an annuity or other insurance company provided guarantee. As noted earlier, the DOL has recognized that guaranteed products may be included in QDIAs. This means that both participants who elect to invest in a portfolio that includes an annuity or annuity-type product, and defaulting participants in QDIAs, can receive the benefits of guaranteed lifetime income in retirement, plus still have a guaranteed, non-volatile return on the annuity during the accumulation phase.

There are options available in the marketplace that offer a guarantee feature. However, the inclusion of a guaranteed investment within a custom model portfolio managed by either the plan sponsor or plan committee – with the assistance of an investment advisor – or by a 3(38) investment manager has been simplified and made more attractive by provisions of the SECURE Act adopted in 2019. That Act added a fiduciary safe harbor for selecting the insurance company that offers a guaranteed contract and for facilitating "portability," that is, the ability of participants to take a distribution of such a contract if their employer changes service providers for the plan and the contract will no longer be held by the plan.[22] (If further investment in the contract is frozen by the employer but the contract is still held by the plan, the portability provision does not apply.)

The fiduciary issues are discussed in the next section of this paper.

Fiduciary Considerations

Selecting QDIAs

The fiduciary safe harbor provided under ERISA Section 404(c)(5) relieves plan sponsors of liability if participants suffer investment losses as a result of their account being invested in the plan's QDIA.[23] This is because the participants are deemed to have exercised control over their accounts notwithstanding the fact that they were defaulted into the QDIA. But the DOL regulatory guidance makes it clear that plan sponsors are not relieved of the responsibility to prudently select and monitor the QDIAs used in their plans:[24]

> *"Nothing in this section shall relieve a fiduciary from his or her duties under part 4 of title I of ERISA to prudently select and monitor any qualified default investment alternative under the plan or from any liability that results from a failure to satisfy these duties, including liability for any resulting losses."*

In other words, plan sponsors must engage in a prudent process to select their plans' QDIA or need to engage a discretionary investment manager to make the selection for them. The process for making this selection is essentially the same as that for any other investment alternative offered in the plan. As the DOL has stated on numerous occasions, a plan sponsor "must engage in an objective, thorough and analytical process that considers all relevant facts and circumstances."[25]

This entails:

- Gathering relevant information about the decision to be made;
- Assessing the information; and
- Making a decision based on the information gathered and the assessment of that information.[26]

In essence, plan sponsors must make an informed and reasoned decision.

In the context of QDIAs, the Government Accountability Office conducted a study in 2011 in which it found significant issues in the TDF market. In its study, it commented on the difficulty plan sponsors had in evaluating TDFs. In its report, it said:

> *"While some plan sponsors conduct robust TDF selection and monitoring processes, other plan sponsors face challenges in doing so. Plan sponsors and industry experts identified several key considerations in selecting and monitoring TDFs, such as the demographics of participants and the expertise of the plan sponsor.* ***Some plan sponsors may face several challenges in evaluating TDFs, such as having limited resources to conduct a thorough selection process, or lacking a benchmark to meaningfully measure performance.*** *Although plan sponsors may use various media in an effort to inform participants about funds offered through the plan, some plan sponsors and others noted that participants typically understand little about TDFs."*[27] [Emphasis added]

Possibly in response to this GAO study, in 2013, the DOL issued a set of "Tips for ERISA Plan Fiduciaries" related to the evaluation of TDFs.[28] The DOL emphasized that plan sponsors need to understand the fund's investments, including the allocations to different asset classes (stocks, bonds, cash), any individual investment funds included in TDFs, and the glide path of TDFs. They also need to investigate the TDFs' fees and investment expenses, including the effect of the expenses of the underlying investments. In the Tips, the DOL explains the importance of looking at the impact of the expenses of the underlying investments as follows:

> *"TDF costs can vary significantly, both in the amount and types of fees. Small differences in investment fees and costs can have a serious impact on reducing long term retirement savings. Do you understand the fees and expenses, including any sales loads, for the TDF? If the TDF invests in other funds,* ***did you consider the fees and expenses for both the TDF and the underlying funds? If the expense ratios of the individual component funds are substantially less than the overall TDF, you should ask what services and expenses make up the difference.*** *Added expenses may be for asset allocation, rebalancing and access to special investments that can smooth returns in uncertain markets, and may be worth it, but it is important to ask."*[29] [Emphasis added]

The DOL stresses the importance of reviewing the cost a TDF, by pointing out that "Small differences in investment fees and costs can have a serious impact on reducing long term retirement savings."[30]

The DOL is making it clear that plan sponsors need to look at more than the cost and performance of a TDF and the quality of its manager. They need to delve more deeply, *i.e.*, understand the investments included in the TDF and the impact that those investments have on the performance of the TDF. They also need to look at the TDF's glide path and consider whether it is appropriate for the plan sponsor's workforce. As the DOL points out in the Tips:

> *"Do you understand the principal strategies and risks of the fund, or of any underlying asset classes or investments that may be held by the TDF?* ***Make sure you understand the fund's glide path, including when the fund will reach its most conservative asset allocation and whether that will occur at or after the target date.*** *Some funds keep a sizeable investment in more volatile assets, like stocks, even as they pass their "target" retirement dates.*[31] [Emphasis added]

As an alternative, the DOL suggests that plan sponsors investigate a customized suite of options for their plans:

> *"[Plan sponsors should] Inquire about whether a custom or non-proprietary target date fund would be a better fit for your plan. Some TDF vendors may offer a pre-packaged product which uses only the*

> *vendor's proprietary funds as the TDF component investments. Alternatively, a 'custom' TDF may offer advantages to your plan participants by giving you the ability to incorporate the plan's existing core funds in the TDF. Nonproprietary TDFs could also offer advantages by including component funds that are managed by fund managers other than the TDF provider itself, thus diversifying participants' exposure to one investment provider."*[32]

The DOL is saying that plan sponsors need to consider the conflicts of interest that a TDF manager has in using only (or a majority of) its own proprietary products and that they look into the possibility that a customized fund could be offered to participants or used as their plan's QDIA. This could also add value to the participants if a plan sponsor decides to include a retirement income component to the target date portfolios.

Realistically, the evaluation of TDFs is a complex undertaking. Even though many TDFs may use the same designation – e.g., the 2050 fund – the TDFs of different providers may be very different in terms of investments and glide paths. In light of this potential confusion, a plan sponsor may want to work with a consultants to assist in the evaluation process.

Custom Model Portfolios

Custom model portfolios may offer a number of advantages to plans and plan sponsors. As noted earlier, a non-custom model portfolio, such as a TDF, is a provider solution that invests in other funds, often proprietary investments of the investment manager. In contrast to a commercially available mutual fund that adjusts the asset allocation based on a hypothetical year of retirement, a custom model portfolio is one that is developed to address the needs of a specific plan's participants and is a portfolio less likely to include proprietary funds. The following are some of the advantages of custom model portfolios:

- Plan sponsors can avoid the responsibility to assess and monitor the conflicts of interest inherent in a commercial portfolio that uses proprietary investments.

- A custom model portfolio should simplify the process of selecting the investments included in the portfolio where the model uses a plan's core options, since the plan sponsor already engages in a prudent process to select and monitor those investments.

- If an investment within the custom model portfolio needs to be replaced, it can be done easily and would not require replacing the entire portfolio, while a plan sponsor cannot modify a TDF without replacing the full suite of TDFs.

- Insurance products, such as fixed annuities, can be used within custom model portfolios and are not subject to the 1940 Act hurdles of using such products in mutual funds.

- Multiple glide paths could be used which can be tailored to the specific demographics of the plan, including different cohorts of employees (*e.g.*, those with access to a defined benefit plan versus those without, or salaried employees versus hourly wage employees)

- A participant's assets outside the custom model portfolio could be considered in determining the model's allocation, providing a broader view of the participant's financial picture.

- The opportunity for a participant to personalize the selection of the custom model portfolio should they choose to engage in the process

The authors are also advised that in some instances, the cost of a custom model portfolio may be less than the fees charged for a non-custom model portfolio.

Evaluation of Retirement Income Options

To this point, this paper has focused on the selection and monitoring of target date funds and managed portfolio

investments, the use of such funds and investments as a plan's QDIA, and the legality, advantages and appropriateness of including a retirement income feature in a QDIA. The last issue to be discussed is what a plan sponsor needs to do to prudently select a retirement income feature.

The SECURE Act created a fiduciary safe harbor for the selection of the insurer that underwrites the retirement income feature through a straightforward and well-defined checklist approach. The safe harbor requires that a plan sponsor obtain specified written representations from the insurance company. By obtaining those representations, a plan sponsor is deemed to have satisfied its responsibility to establish the financial capability of the insurer to meet its obligations under the retirement income product (unless the plan sponsor has information that would cause it to question the representations).[33] However, plan sponsors are required to consider the cost, product features and administrative services to be provided under the product and determine that the cost is reasonable.[34] Plan sponsors are not required to select the lowest cost option, but that they may (but are not required to) consider "the value of the contract, including features and benefits of the contract and attributes of the insurer…in conjunction with the cost of the contract."[35]

The process of deciding to include a retirement income alternative in a plan and in selecting the insurer and the product is summarized in the following steps. A plan sponsor, likely with the help of a consultant, should:

- Determine whether to offer a retirement income feature in the plan, and in particular, whether the feature should be included in a custom model portfolio that may be the plan's QDIA, and if so, the type of product, *e.g.*, annuities versus other forms of a guaranteed retirement income products, and, if an annuity is selected, the type of annuity to be provided.

- Once the type of retirement income product is selected, a plan sponsor needs to identify the carriers that issue competitive products of that type, consider the administrative services they offer and gather information about the products

- After finalizing the selection of the product and thus the carrier, a plan sponsor would need to obtain the insurer's representations and not have any information that is contrary to those representations.

In considering whether to offer a retirement income feature in the plan, a plan sponsor would also want to assess other issues regarding its plans, including whether the plan should permit periodic distributions (as opposed to only allowing for a full lump sum distribution upon retirement and minimum required distributions) so that the investment could be left in the plan when a participant retires…though this is not required, since most retirement income products can also be distributed to IRAs.)

In assessing the type of product and the ultimate selection of the product, a plan sponsor needs to consider issues such as: the terms of the product and how well it matches the needs of the participants; the cost of the product and whether it is reasonable in relation to the benefits the product offers; and the administrative services to be provided by the insurer. The consideration of cost does not require a plan sponsor to select the lowest cost alternative but to select a product in which the cost is reasonable in relation to the value provided to participants.

One factor to consider is that there are a number of different types of annuities, each of which has advantages. For example, a fixed annuity has a specified rate of return, which can be beneficial in both the accumulation phase, when participants are putting money into the annuity, and the decumulation phase, when participants are looking to the annuity as a source of predictable, sustainable lifetime income and want to avoid potential market losses on their retirement savings. An alternative is a variable annuity, in which the premiums paid on the annuity are invested in securities that may vary in value, thus providing the potential for significant growth over time. These are among the factors that a plan sponsor should consider in selecting the product to be offered. Another factor is how to deploy the lifetime

income solution. If left to participant choice, there is some likelihood that few would take advantage of the lifetime income alternative (because of a lack of understanding of annuities and the benefits they offer for both accumulation and decumulation). Usage in the QDIA would ensure that defaulting participants could obtain the benefit of the guaranteed income if they elect to annuitize. However, participants who affirmatively decide that they do not want to invest in a portfolio that includes annuities would have the ability to move their account to other options in the plan.

In connection with selecting the product, several other factors are worth noting. Under ERISA, plan sponsors are required to make reasonable choices after considering the relevant factors that are known at the time the decision is being made. In the context of selecting a provider, in addition to the safe harbor representations, plan sponsors might want to consider other factors, such as: the reputation of the company; the company's history of providing and servicing retirement income products; to the extent readily available, the company's regulatory compliance history; and the company's ratings by the major ratings agencies. The choice does not have to be perfect, and there is not a requirement to predict the future. But there is an obligation to engage in the prudent process described in this paper, and an obligation to revisit the decision periodically (the duty to monitor). In the context of cost, plan sponsors need to determine whether the cost is reasonable by making a comparison to other similar products in the marketplace. As the SECURE Act indicates, there is no requirement to select the lowest cost product, only to determine that the price is competitive. Finally, in assessing the administrative services to be provided under the product, a plan sponsor would take into account the carrier's history of offering and administrating similar products and its reputation as a provider of those benefits. One approach that a plan sponsor may want to take is to select a carrier with a history of offering and managing annuities and with a lengthy track record of strong financial ratings.

Conclusion

Plans sponsors can help their participants deal with challenges they face in retirement by providing custom model portfolios that include a guaranteed lifetime income feature, such as a fixed annuity. Custom model portfolios which include a fixed annuity may be designated investment alternatives for participants to direct the investment; and they may serve as the plan's qualified default investment alternative.

Consultants are able to provide a value-added service to plan sponsor clients by helping select the plan's investment alternatives, designing the glide path and evaluating guaranteed lifetime income alternatives. They can also design a custom model portfolio, since a custom portfolio can be specifically designed to meet the characteristics of the sponsor's workforce.

The fiduciary considerations for consultants and their plan sponsor clients in selecting a non-custom model, such as a mutual fund or in deciding on a custom model portfolio are essentially the same, that is, the asset allocation, the appropriateness of the investment for the plan and its participants, the cost of the product, the underlying investments (for example, in a TDF), and the like. In fact, the process may be simpler if a custom model portfolio uses the plan's designated investment alternatives, since the plan sponsor presumably already engaged in a prudent process in selecting those investments. And, where a custom model portfolio includes a guaranteed lifetime income feature, the SECURE Act makes the process of selecting the insurer more straightforward and less concerning for plan fiduciaries.

Endnotes

1 2020 TIAA Retirement Insights Survey: "Nearly half (47%) of plan sponsors consider plan participants to be above average in their ability to plan for retirement, yet only 24% of employees would say the same."

2 *Id.* "Nearly 9 in 10 plan sponsors say the plan should provide secure retirement income. But income replacement is more of a priority for 403(b) plan sponsors (46%) than 401(k) sponsors (30%)."

3 The Setting Every Community Up for Retirement Enhancement Act of 2019, referred to in this paper as the "SECURE Act." *See* Section 204, Fiduciary safe harbor for selection of lifetime income provider.

4 ERISA Section 404(e).

5 Secure Act, Sections 109, Portability of lifetime income options, and 203, Disclosure regarding lifetime income.

6 This assumes that the model portfolio either uses only the designated investment alternatives offered in the plan or otherwise satisfies the definition of a QDIA.

7 Blanchett, David and Bruns, Dan, *How Sticky is Your Plan's Default Investment?*, Morningstar Investment Management LLC (May 17, 2019). This research indicates that managed accounts, i.e., model portfolios, tend to be retained by defaulting participants at a higher percentage than TDFs or balanced funds.

8 *See* footnotes 16-18 below.

9 ERISA Regulation Section 2550.404c-1.

10 *Id.* at subsections (b)(3)(A), (B)(3) and (C).

11 *See*, Hopkins, Jamie and Littell, Dave, *2017 RICP® Retirement Income Literacy Report*, The American College Center of Financial Services (2017) and Belbase, Anek and Sanzenbacher, Geoffrey T., *Cognitive Aging and the Capacity to Manage Money*, Center for Retirement Research at Boston College (January 2017).

12 ERISA Section 404(c)(5).

13 ERISA Regulation 2550.404c-5. The investment alternatives are described in subsection (e) and capital preservation alternatives like money market funds are dealt with in subsections (e)(4)(iv) and (v).

14 The DOL noted in the preamble to the adoption of the QDIA regulation the following: "Although investment management services are included within the scope of relief, the Department notes that relief similar to that provided by this regulation is available to plan fiduciaries under the statute [referring to Section 3(38) investment managers]. The Department included investment management services within the scope of fiduciary relief in order to avoid any ambiguity concerning the scope of relief available to plan fiduciaries in the context of participant directed individual account plans." *Default Investment Alternatives under Participant Directed Individual Account Plans*, 72 Fed. Reg. 60452, fn. 8 at page 60462 (October 27, 2007).

15 These are often referred to as a 3(38) fiduciary, which are defined in ERISA Section 3(38). If a 3(38) fiduciary is appointed by a plan sponsor, the responsibility for selecting investments within the scope of the fiduciary's discretion is shifted from the plan sponsor under ERISA Section 405d)(1).

16 DOL Regulation Section 404c-5(e)(4)(vi).

17 DOL Information Letter to Mark Iwry, dated October 23, 2014. In a subsequent information letter, the DOL took the position that where an annuity sleeve in a fund did not permit the transfer of the investment within the timelines of the QDIA regulation, the fund would not qualify as a QDIA. However, the DOL pointed out that the selection of the fund could still be a prudent decision for a fiduciary to make. *See* DOL Information letter dated December 22, 2016.

18 IRS Notice 2014-66

19 Among other requirements, the regulation provides that a defaulting participant must be able to transfer out of the QDIA "to any other investment alternative available under the plan with a frequency consistent with that afforded to a participant or beneficiary who elect to invest in the qualified default investment alternative, but not less frequently than once within any three month period." ERISA Regulation Section 2550.404c-5(c)(5)(i).

20 ERISA Regulation Section 2550.404c-5(c)(5)(ii)(A).

21 ERISA Section 405(d)(1).

22 SECURE Act sections 204 (adding ERISA Section 404(e)) and 109 (adding Code section 401(a)(38) and making other implementing amendments), respectively.

23 ERISA Section 404(c)(5)(A), making reference to Section 404(c)(1).

24 DOL Regulation Section 2550.404c-5(b)(2).

25 *See, for example*, DOL Information Letter dated December 22, 2016.

26 *See, for example*, DOL Regulation Section 2550.404a-1.

27 "DEFINED CONTRIBUTION PLANS: Key Information on Target Date Funds as Default Investments Should Be Provided to Plan Sponsors and Participants," Government Accountability Office (January 2011).

28 DOL Publication, "Target Date Retirement Funds - Tips for ERISA Plan Fiduciaries," February 2013, available at https://www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/fact-sheets/target-date-retirement-funds.pdf (referred to as "the Tips").

29 *Id. at tip number 4.*

30 *Id. at footnote 2.*

31 *Id. at tip number 3.*

32 *Id. at tip number 5.*

33 ERISA Section 404(e)(2)(A) and (B).

34 *Id. at subsections (1)(B)(ii) and (C)(ii).*

35 *Id. at subsection (3).*

To learn more about how to integrate lifetime income in target date solutions or managed accounts, including the TIAA Secure Income Account, please contact TIAA_DCIO_Support@tiaa.org.

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Certain products may not be available to all entities or persons.

The ability to annuitize is subject to plan rules. Annuitization is a permanent decision and once lifetime income payments has been selected you are unable to change to another option.

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