Fiduciary Considerations In Using Model Portfolios

Providing Retirement Income Features To Help Participants Achieve A Secure Retirement

---

Executive Summary

By Fred Reish and Bruce Ashton

March 2022

Participants in defined contribution plans face a serious challenge in retirement, knowing how to manage their retirement savings so the money will last for their lifetimes. Employers are becoming increasingly aware of this issue and are looking to help their employees with both saving and investing while they are working so they can have a financially secure retirement. A key component in providing this help is for employers to consider offering investments in their plans that enable participants to meet this retirement challenge.

One approach employers can take is to offer a custom model portfolio that is tailored to the needs of the workforce and includes a guaranteed lifetime income contract, such as a fixed annuity. These custom portfolios can be offered as one of the options in a plan's core lineup and can also be used as the plan's qualified default investment alternative (QDIA).

In the past, a perceived barrier to offering a custom portfolio that included a guarantee was uncertainty about the fiduciary process for selecting the insurance company that provided the guaranteed contract. Recent legislation has eliminated that concern by creating a fiduciary safe harbor for selecting and monitoring insurance companies that provide annuities (or other forms of guaranteed lifetime income contracts). As a result, the process of selecting an insurance company is easier and less concerning for plan sponsors. (For the sake of simplicity, we use the term "plan sponsor" to refer to the responsible fiduciary of a plan.)

Background

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. Unfortunately, only about 25% of participants believe they can competently make those decisions.[1] While auto-enrollment and target-date funds have lessened the decision-making burden during the accumulation years, participants still face a number of challenges in retirement. These include:

- The longevity challenge, *i.e.*, how long they may live and how much money they will need in retirement;
- The withdrawal rate challenge, *i.e.*, how much money they can take from their retirement savings on a periodic basis so that it will last;
- The investment challenge, *i.e.*, how to invest to protect themselves from market downturns, changing interest rates and inflation;
- The cognitive impairment challenge, *i.e.*, understanding that they may not be able to manage their money competently as they age, which makes it important to take steps during their working years to protect against this problem.

In recent years, plan sponsors have begun to understand and address these needs.[2] This has led to increased willingness to add lifetime income as a plan option. By lifetime income, we are referring to an insured source of payments that provides secure income for the life of a participant or the participant and spouse. The source of predicable and sustainable income that is guaranteed for life can only be provided through an insured product, such as an annuity or other form of insured income product.

In this paper, we refer to non-customized and customized model portfolios. Here's the difference:

- A non-customized portfolio is one that is generally available in the securities markets, such as a target date mutual fund.
- A customized model portfolio is one that is tailored or personalized to the plan sponsor's workforce.

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, which is more difficult in a non-customized portfolio; and better tailoring the asset allocation and glide paths to the demographics of the sponsor's workforce, which is generally not possible with a non-customized portfolio. Note that a plan's consultants are able to provide a value-added service to plan sponsors by designing and managing the custom model portfolios.

Discussion

Fiduciary Considerations

Before getting into a discussion of model portfolios, we need to provide some background. In selecting a plan's investments and its qualified default investment alternative (QDIA), a plan sponsor must engage in a prudent process. This means engaging in "an objective, thorough and analytical process that considers all relevant facts and circumstances."[3] 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.[4]

In essence, plan sponsors must make an informed and reasoned decision. Failing to engage in this process creates risk of fiduciary liability. In the context of a model portfolio that includes a lifetime income feature, plan sponsors have needed to use this fiduciary process to select the issuer of the lifetime income contract.

The enactment of the SECURE Act in 2019 reduced much of this fiduciary risk for selecting an insurer through the adoption of an amendment to the Employee Retirement Income Security Act (ERISA).[5] This amendment created a fiduciary safe harbor for the selection of the insurer.[6] The safe harbor requires that fiduciaries obtain specified financial and regulatory representations from an insurance company. So long as the plan sponsor does not have information to the contrary, it may rely on those representations and is protected from exposure to liability if the insurer is unable to satisfy its financial obligations to participants.

Custom vs. Non-Custom Portfolios

If a plan sponsor includes a guaranteed retirement income contract (*e.g.*, a fixed annuity) in its plan, participants will need to decide whether to invest a portion of their account in the guaranteed option. Unfortunately, participants may not have the knowledge to decide how to effectively allocate their assets among the different investment options (*e.g.*, mutual funds) and insurance products on the plan menu. There are a couple of approaches a plan sponsor might take, working with its consultant, to help participants with those decisions:

- Offer a non-customized model portfolio[7] that includes an allocation to a lifetime retirement income contract along with diversified equity and fixed income investments.
- Alternatively, offer a customized professionally managed model portfolio.
- Either of these options could also serve as the plan's QDIA.[8]

Mutual fund target date funds (TDFs), which automatically adjust the asset allocation in participant accounts, or other non-custom model portfolios that operate as a TDF, can be helpful to participants by relieving them of many of the investment decisions they would otherwise need to make. That said, a custom model portfolio may provide a better alternative for plan sponsors because of the ability to leverage their prudent selection and monitoring of the plan's investment options. With a custom model portfolio, plan sponsors can also avoid the conflicts of interest and possibility of underperforming funds within the TDF that are inherent in a TDF that predominantly uses proprietary investments.

Further, plan sponsors are able to delegate discretionary authority to the plan's investment consultant or to a financial service provider to serve as an investment manager of custom portfolios. When selecting an investment manager who qualifies under ERISA Section 3(38), plan sponsors are able to shift the fiduciary liability for decisions about the investments 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).[9] A custom model portfolio would be tailored to the demographics of the sponsor's workforce, while a non-custom portfolio would not. While the process for creating such a customized model portfolio, 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.

QDIAs

We mentioned earlier qualified default investment alternatives or QDIAs. When participants exercise control over the investment of their accounts, the plan sponsor is not liable for their investment decisions. However, if participants don't make investment decisions, then the plan sponsor must decide how to invest the accounts of these "defaulting participants." So long as participants are given notice of how their account will be invested and have the ability to opt out (and do so without penalty within the first 90 days),[10] ERISA provides a fiduciary safe harbor if defaulting participant monies are invested in QDIAs.

To constitute a QDIA, the investment 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 created for a specific plan.

The DOL has acknowledged that annuities could be part of a QDIA.[11] 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.

Evaluation of Retirement Income Options

While the SECURE Act created a fiduciary safe harbor for the selection of the insurer that underwrites the retirement income contract through a straightforward and well-defined checklist approach, it does not have a safe harbor for the selection of the contract itself. In selecting the contract, plan sponsors must consider the cost, product features and administrative services provided for the contract and determine that the cost is reasonable.[12] Plan sponsors are not required to select the lowest cost option, but 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."[13]

The key to a compliant process is to have information about the choices available in the marketplace and to do a comparative analysis. In that regard, the process is essentially the same as for selecting investments such as mutual funds.

Conclusion

Plans sponsors can help their participants deal with their retirement by providing custom model portfolios that include a guaranteed lifetime income product, such as a fixed annuity. Those custom model portfolios may be designated investment alternatives for participants in the plan's core lineup and they may also serve as the plan's qualified default investment alternative.

Consultants provide valuable services to plan sponsors by helping select the plan's investment alternatives, designing the glide path and evaluating guaranteed lifetime income alternatives. Consultants can also provide additional value by designing a custom model portfolio, specifically to meet the characteristics of the sponsor's workforce.

The fiduciary considerations for consultants and their plan sponsor clients in designing a custom portfolio or in selecting a non-custom product are essentially the same. 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.

To learn more about custom model portfolio solutions available through the TIAA RetirePlus Series® or to receive a checklist to assist in evaluating the decision to include a retirement income alternative in a plan and in selecting the insurer please contact your TIAA representative today.

The TIAA RetirePlus Series model portfolios are asset allocation recommendations developed in one of three ways, depending on your plan structure: i) by your plan sponsor, ii) by your plan sponsor in consultation with consultants and other investment advisors designated by the plan sponsor, or iii) exclusively by consultants and other investment advisors selected by your plan sponsor whereby assets are allocated to underlying mutual funds and annuities that are permissible investments under the plan. Model-based accounts will be managed on the basis of the plan participant's personal financial situation and investment objectives (for example, taking into account factors such as participant age and risk capacity as determined by a risk tolerance questionnaire).

No registration under the Investment Company Act, the Securities Act or state securities laws – a model is not a mutual fund or other type of security and will not be registered with the Securities and Exchange Commission as an investment company under the Investment Company Act of 1940, as amended, and no units or shares of the model will be registered under the Securities Act of 1933, as amended, nor will they be registered with any state securities regulator. Accordingly, the model is not subject to compliance with the requirements of such acts, nor may plan participants investing in underlying investments based on the model avail themselves of the protections thereunder, except to the extent that one or more underlying investments or interests therein are registered under such acts.

TIAA RetirePlus® and TIAA RetirePlus Pro® are administered by Teachers Insurance and Annuity Association of America ("TIAA") as plan recordkeeper. Transactions in the underlying investments invested in, based on the models, on behalf of the plan participants are executed through TIAA-CREF Individual & Institutional Services, LLC, member FINRA.

More information about the TIAA RetirePlus Series can be found at tiaa.org/public/plansponsors/investment-solutions/custom-default-options.

This paper was commissioned by TIAA. Faegre Drinker is not affiliated with TIAA.

2102753A (4/22)

For institutional investor use only. Not for use with or distribution to the public.

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

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

5 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.

6 ERISA Section 404(e).

7 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.

8 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. Guidance issued by the Department of Labor (DOL) makes it clear that inclusion of a guaranteed lifetime income feature in a QDIA is permissible. See footnote 10 below

9 ERISA Section 405(d)(1).

10 ERISA Section 404(c)(5). *See also* IRS Notice 2014-66 and 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.

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

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

13 *Id.* at subsection (3).