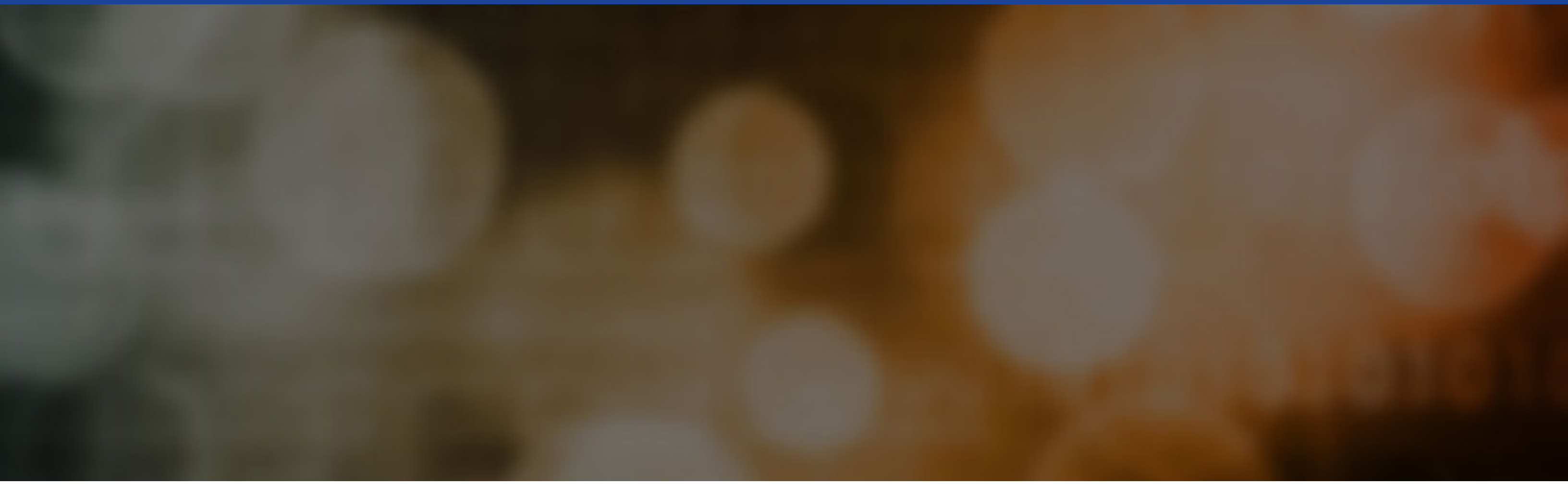

GUARANTEED RETIREMENT INCOME

APPROPRIATE CONSIDERATIONS FOR ERISA PLAN FIDUCIARIES

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Introduction

Historic market volatility, sweeping changes to legislation, regulation and retirement income solutions have aligned in a way that requires plan sponsors to act. Significant declines in the first quarter of 2020 have shaken confidence among plan participants. In one recent survey, 40 percent of respondents said that they are most concerned about market risk, and that same percentage reported fears of having enough money for their retirement.[1]

Longevity risk has historically been one of the top concerns for pre-retirees, and eight out of 10 respondents said they would be more likely to leave money in their plan if their employer offered an investment option specifically to help retirees draw income during retirement.[2] Another survey reports that 61% of respondents said they were looking for more information on annuities and how they could be part of their employer-sponsored DC plan.[3] The same study indicated that 77% of people currently enrolled in an employer-sponsored DC plan said that if it were offered, they would consider adding lifetime income as an option in their plan.[4]

The Employee Retirement Income Security Act ("ERISA") requires plan fiduciaries to make prudent decisions and to act solely in the interests of their participants and beneficiaries.[5] Department of Labor ("DOL") regulations interpret the duty of prudence to require fiduciaries to:

> **"give appropriate consideration to those facts and circumstances that…the fiduciary knows or should know are relevant to the particular investment or investment course of action involved..."[6]**

Would record levels of participant concerns not be the sort of facts and circumstances that fiduciaries know or should know are relevant and, therefore, a foundation for prudent decision-making? If so, then why are so few plans offering guaranteed income investment options?

This paper examines the evolution of guaranteed income products, the impact of recent legislation and regulatory guidance and describes best practices for fiduciaries to consider when evaluating whether to add retirement income solutions to their defined contribution plans.

Traditional Barriers to Adoption: Safe Harbor, Portability & Disclosure

The universe of guaranteed solutions can be broken down into three general categories:

- i **deferred income annuities**
- ii **Guaranteed Lifetime Withdrawal Benefits ("GLWBs"); and**
- iii **immediate income annuities.**

Deferred income annuities provide fixed income payments, beginning at a predetermined age, to participants for life, regardless of the market value of their account balance at the time the payments begin. Once purchased, participants are locked in and do not have access to liquidate the amounts allocated to the annuity contract.

GLWBs, on the other hand, offer participants the ability to withdraw a set amount from their accounts throughout retirement without obligating them to do so – even if the account value is exhausted by the withdrawals. Consequently, GLWBs offer more flexibility on a participant-by-participant basis and greater liquidity than a standalone annuity.

An immediate fixed income annuity gives participants the option to convert all or some of their account into a fixed stream of payments for life (or the life of a spouse) or a predetermined period or both. Once converted, participants no longer enjoy the potential for growth of the annuitized balance.

For years, one of the primary reasons cited by plan sponsors and consultants for not making available income guarantees to participants was the risk related to selecting an insurance provider. There was no official playbook or safe harbor to follow, so many fiduciaries feared that they would be held liable if guarantees were not honored in the future.

Others worried about the portability of guaranteed income products given that employees are changing jobs more frequently than in the past. Additionally, the proprietary nature of traditional guaranteed products often resulted in a forced surrender of the benefits if the plan sponsor elected to change providers. Fiduciaries were wary of causing participants to sacrifice a benefit for which they had been paying and/or be potentially subject to surrender charges and fees.

Another concern related to "reverse sticker shock" associated with participants realizing their savings, once converted to a monthly income stream, was insufficient to support the lifestyle they envisioned as pre-retirees. Fiduciaries were nervous that the shortfall may be attributed, rightly or wrongly, to decisions they made on the participants' behalf.

Fortunately, legislation and regulations have cleared the way for fiduciaries by providing liability safe harbors and specific guidance, and innovation by the investment providers has resulted in more choices, greater flexibility and portability and less expensive guarantees.

Why Now?

In December of 2019, the SECURE Act ushered in robust and clearly defined protections and requirements for plan fiduciaries, including a "Fiduciary Safe Harbor for Selection of Lifetime Income Provider"[7] and guidelines concerning "Portability of Lifetime Income Options."[8] Another provision, entitled "Disclosure Regarding Lifetime Income,"[9] mandates that plan sponsors provide participants with an illustration of the monthly payments the participant would receive if the total account balance were used to provide lifetime income streams, at least annually.

According to Congress,[10] the Fiduciary Safe Harbor for Selection of Lifetime Income Provider:

> "provides certainty for plan sponsors in the selection of lifetime income providers, a fiduciary act under ERISA. [Now], fiduciaries are afforded an optional safe harbor to satisfy the prudence requirement with respect to the selection of insurers for a guaranteed retirement income contract and are protected from liability for any losses that may result to the participant or beneficiary due to an insurer's inability in the future to satisfy its financial obligations under the terms of the contract. *Removing ambiguity about the applicable fiduciary standard eliminates a roadblock to offering lifetime income benefit options under a defined contribution plan.*"

Portability of Lifetime Income Options:

> "permits qualified defined contribution plans, section 403(b) plans, or governmental section 457(b) plans to make a direct trustee-to-trustee transfer to another employer-sponsored retirement plan or IRA of lifetime income investments or distributions of a lifetime income investment in the form of a qualified plan distribution annuity, if a lifetime income investment is no longer authorized to be held as an investment option under the plan. *The change will permit participants to preserve their lifetime income investments and avoid surrender charges and fees.*"

Disclosure Regarding Lifetime Income:

> "requires benefit statements provided to defined contribution plan participants to include a lifetime income disclosure at least once during any 12-month period. The disclosure would illustrate the monthly payments the participant would receive if the total account balance were used to provide lifetime income streams, including a qualified joint and survivor annuity for the participant and the participant's surviving spouse and a single life annuity. Disclosure in terms of monthly payments will provide useful information to plan participants in correlating the funds in their defined contribution plan to lifetime income. *Plan fiduciaries, plan sponsors, or other persons will have no liability under ERISA solely by reason of the provision of lifetime income stream equivalents that are derived in accordance with the assumptions and guidance under the provision and that include the explanations contained in the model disclosure.*"

Given these developments, liability-related concerns for not including guaranteed income have been substantially mitigated, and a new generation of solutions, including non-proprietary, multi-manager and/or multi-insurer strategies, offer enhanced portability, risk shifting and diversification.

Not only have income solutions become more portable, many income providers have simplified their structure and created more transparent and competitive pricing, including eliminating costly market value adjustments and surrender charges.[11] Indeed, some now offer lifetime income guarantees without the participant ever having to annuitize the contract.

As for the potential for reverse sticker shock, the DOL recently published an “interim final” regulation in response to the SECURE Act. Beginning next August, plan sponsors will be required to provide participants with lifetime income illustrations at least annually.[12] At a minimum, this increased awareness will result in plan sponsors having to field more questions from participants regarding guaranteed income options.

Given increasing demand from participants, coupled with robust support from policy makers and innovations in income solutions, we believe plan sponsors would be well-served to give “appropriate consideration” to options that are becoming increasingly relevant when making prudent decisions about investment options that align with the interests of plan participants.

Guaranteed Income & QDIAs

There are three ways fiduciaries can go about providing participants access to guaranteed income solutions through their employer-sponsored plan:

- i **adding it as a standalone option alongside the plan's other Designated Investment Alternatives ("DIAs");**
- ii **including it within a Qualified Default Investment Alternative ("QDIA"); and/or**
- iii **making it available both on a standalone basis and within the plan's QDIA.**

In all cases, fiduciaries will need to perform the same analysis to avail themselves of the safe harbor created by the SECURE Act. Once it has been decided that a plan will offer guaranteed income, the question then becomes, how will it be offered in a way that benefits the most participants?

Deciding on how much to allocate to guaranteed income investments can be difficult for the average participant. In many plans, prudence may require that participants have the option to leverage the expertise of an institutional fiduciary (i.e., the plan sponsor or a 3(38) manager) to invest their account for them, as is the case with a QDIA. Even in the case of QDIAs, many participants panic during market downturns and lock in the losses by "selling at the bottom."

For those who have had access to guaranteed income, one report suggests they are "2.5 times more likely to stay the course and maintained 38% higher contribution rates than those without guarantees."[13] Making retirement income solutions available both as a standalone investment option (for those participants who are actively seeking it out) as well as part of a QDIA (for those with a lesser degree of involvement planning for their retirement) has the potential to provide better outcomes for participants as a whole.

While there are three categories of QDIAs, target date funds ("TDFs") have run away with the lion's share of defaulted participant assets.[14] Managed accounts providers have found themselves resigned to a very distant second place despite recent gains in availability due to enhancements in recordkeeping technologies and advisor-managed solutions. Risk-based QDIAs (i.e., balanced funds or moderate asset allocation portfolios), which require fiduciaries to determine the anticipated risks and returns are "appropriate for participants of the plan as a whole," inherently open the door to scrutiny with younger participants arguing they were invested too conservatively, while older workers may claim that their plans' fiduciaries should have known they couldn't tolerate the volatility associated with higher levels of equity exposure at retirement.

Both TDFs and managed accounts share a similar feature; each must contain a mix of equity and fixed income exposures and automatically become more conservative over time. As a result, participants do not have to worry about when they should start "de-risking" their accounts to limit potential volatility as they get closer to the time when they need to ensure their savings can stretch out over their post-retirement lives. That said, many participants are still prone to getting out of the market as volatility increases and getting back in at the wrong time, as previously discussed, and have lower balances at retirement than they would have had they remained invested. A traditional QDIA does not solve this problem.

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Emerging Non-Proprietary Alternatives

An emerging hybrid solution involves using TDFs as QDIAs for younger workers and then, at some point determined by plan fiduciaries, shifting to managed accounts. This approach is supported by the proposition that younger participants may not be engaged enough to capitalize on the value of the additional customization offered by a managed account service. For example, participants are expected to affirmatively input more data points relating to their unique circumstances so the managed account strategy can conform to their personal needs. Older participants, on the other hand, are expected to have more complex financial situations, become more engaged as they approach retirement and, therefore, are expected to supply the type of information to the managed account provider that it needs to deliver more customized value. According to this theory, younger workers avoid the drag on accumulation by not paying a premium for a service they are unlikely to use.

But are we not still talking about participants who were not sufficiently engaged to direct the investment of their individual accounts? These participants are typically defaulted into QDIAs for a reason; they do not want to take control and would prefer someone to "do it for them." It remains to be seen how many older workers, who were defaulted for failing to direct their investments, will take affirmative steps to avail themselves of the additional benefits offered by professionally managed accounts. The managed account service may not, in and of itself, give participants the confidence to stay invested when they experience what would otherwise be short-term losses.

Plan sponsors can outsource the management of the QDIA to a third-party investment manager or discretionary trustee.

On the other hand, a shift to retirement income producing investments does not require a higher degree of involvement from defaulted participants as they approach retirement. Fiduciaries can structure the QDIA strategy so that it automatically provides older workers the benefit of having the ability to guarantee a percentage of income while giving the younger members of the workforce a lower cost solution through which to accumulate retirement savings. Once they reach a specified age, they are automatically moved into a TDF that provides some degree of guaranteed income. We refer to this method as a Dual QDIA or DQDIA. The DQDIA has both the ability to protect fiduciaries, who rely upon the new safe harbor, and participants, who are likely to remain invested during market downturns.

Regulatory Guidance

According to the QDIA rules, a default investment must be managed by either:

- i **an investment company (i.e., an asset manager of a TDF);**
- ii **an investment manager, within the meaning of section ERISA Sec. 3(38);**
- iii **a trustee of the plan; or**
- iv **the plan sponsor, or a committee comprised primarily of employees of the plan sponsor, which is a named fiduciary.**[15]

In other words, plan sponsors can outsource the management of the QDIA to a third-party investment manager or discretionary trustee.

The ability to bifurcate a plan's QDIA is well established. In 2008, shortly after the DOL finalized the QDIA regulation, it published Field Assistance Bulleting ("FAB") 2008-03 that answered a series of frequently asked questions. The DOL clearly resolved the question: "Can a plan sponsor use two different QDIAs, for example, one for its automatic contribution arrangement, but another for rollover contributions?" It stated, "Yes. Nothing in the QDIA regulation limits the ability of a plan sponsor to use more than one QDIA, so long as all requirements of the regulation are satisfied with respect to each QDIA."[16]

The concept of embedding guaranteed income in TDFs is also not new or novel. Indeed, the QDIA regulation itself states that:

> "an investment product will not fail to be a QDIA 'solely because the product or portfolio is offered through variable annuity or similar contracts or through common or collective trust funds or pooled investment funds and without regard to whether such contracts or funds provide annuity purchase rights, investment guarantees, death benefit guarantees or other features ancillary to the investment [product.]'"[17]

Moreover, as far back as 2014, the Internal Revenue Service ("IRS") blessed the concept by declaring that income solutions that are only available to older participants in TDFs would not be viewed as discriminatory under the Tax Code[18] and both the IRS and DOL issued final rules on the use of annuities as part of an effort to encourage lifetime income and enhance retirement security.

If the guaranteed income solution is offered in connection with a TDF, fiduciaries will also be well served to follow the DOL's Tips. While the QDIA rules do provide relief to plan sponsors, it is not absolute. The QDIA still needs to be a prudent choice and fiduciaries need to give appropriate consideration to relevant facts and circumstances. When it comes to selecting TDFs, the DOL Tips encourage fiduciaries to, among other things:

> "…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. 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."[19]

When the DOL, as the primary regulator of fiduciary conduct, articulates what it considers to be relevant facts and circumstances, it would be difficult to argue that such guidance was not, at a minimum, something fiduciaries "should have known" to be relevant. Prudence, therefore, dictates that fiduciaries give appropriate consideration to non-proprietary, multi-manager/multi-insurer solutions.

For plan sponsors who may not have the time or expertise to take on this level of analysis prudently, the DOL confirmed they can hire third-party fiduciaries to select the provider of insurance contracts. In a 2014 "information letter," which also clarified that incorporating guaranteed income features will not violate the QDIA rules. According to the DOL, "…[a]ssuming the plan sponsor appropriately discharges its duties as the appointing fiduciary, it will not be liable for any acts or omissions of the investment manager..."[20]

Conclusion

As participants continue to ask for guaranteed income protections, and with policymakers fully supporting their inclusion in employer-sponsored plans, plan sponsors and investment fiduciaries should, at a minimum, give it appropriate consideration. Once determined it would be prudent, then bifurcating the QDIA into growth and guaranteed products is allowable and provides fiduciaries and participants with the best of both worlds.

Adopting a DQDIA can diversify exposure generally and be tailored based upon the demographics and behaviors of particular participant populations. The new safe harbor provides clear legal protection for plan sponsors (or third parties if they choose to outsource fiduciary functions). From a practical perspective, participants that stay invested as a result of having the comfort of knowing they can withdraw guaranteed income are more likely to achieve their goals and less likely to blame their employers if they do not.

Sources

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"The plan sponsor, as the appointing fiduciary, must prudently select the investment manager and monitor the selection at reasonable intervals, in such manner as may be reasonably expected to ensure that the investment manager's performance has been in compliance with the terms of the Plan and statutory standards, and satisfies the needs of the Plan."