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Employee Benefit Plan Review

About 15 Years After The Pension Protection Act of 2006, Is It Time for a Full Review of a Plan's QDIA?

By Tony Sabos and Michael Chard

Inertia: n. A tendency to do nothing or to remain unchanged.[1]

For defined contribution ("DC") plans like 401(k) plans, the Pension Protection Act of 2006 ("PPA") was a watershed event. The PPA provided key provisions to improve the retirement readiness of DC plan participants with automatic features – namely, auto enrollment, auto escalation and "auto investment" via a qualified default investment alternative ("QDIA"). These provisions cleverly used the inertia of plan participants to get them on a better path to saving for retirement. Over the last 15 years, these auto features have been one key reason for improved retirement savings for many Americans – young and old.

Now, about 15 years after the PPA, should plan sponsors revisit these key provisions? To start, the first two decisions – auto enrollment and auto escalation – are settlor/plan sponsor decisions impacting the plan document. These provisions carry no ongoing ERISA fiduciary liability. The success of auto escalation since the PPA prompted lawmakers to raise the safe harbor limit from 10 to 15 percent of employee pay in the SECURE Act of 2019. A Callan survey shows that 27 percent of plan sponsors expect to increase the auto-escalation cap to 15 percent, and four percent to somewhere between 10 percent and 15 percent.[2]

The third decision – selecting the QDIA – is a fiduciary decision, which carries ongoing fiduciary oversight. Here, fiduciaries must comply with their duty to monitor the QDIA's performance. The QDIA choice is probably the most visible decision that a defined contribution plan fiduciary makes. However, one could argue that plan fiduciaries should revisit their entire decision process for the QDIA – seeing that it has been up to 15 years since it was made. A lot has changed over this time, and, as fiduciaries, their number one responsibility is to discharge their "duties with respect to a plan solely in the interest of the participants and beneficiaries."

Many plans still use the same QDIA they initially selected. A bit of inertia from the plan fiduciary perspective? Is the QDIA decision, made so long ago, still in the interest of participants and beneficiaries?

Background

QDIA regulations were published by the Department of Labor's Employee Benefits Security Administration in October 2007 with a fact sheet summarizing these rules in April 2008.[3] This Fact Sheet highlights the key rules

that plan fiduciaries must follow to receive safe harbor relief from fiduciary liability for investment outcomes.

Four types of QDIAs are provided:

1. A product with a mix of investments that takes into account the individual's age or retirement date (an example of such a product could be a life-cycle or targeted-retirement-date fund);
2. An investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date (an example of such a service could be a professionally managed account);
3. A product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual (an example of such a product could be a balanced fund); and
4. A capital preservation product for only the first 120 days of participation (an option for plan sponsors wishing to simplify administration if workers opt-out of participation before incurring an additional tax).[4]

The Fact Sheet also highlights that the final regulation does not absolve fiduciaries of the duty to prudently select and monitor QDIAs.[5]

In practice, the fourth type of QDIA – a capital preservation fund for a limited time – is rarely used by plan fiduciaries. So, most plan fiduciaries have selected from the other three – target date, managed account or single balance fund. The vast majority of plan fiduciaries have selected the first one – typically using a target date fund series.

A recent survey from November 2021 by Plan Sponsor shows that use of a target date fund series as their QDIA ranges from 68 percent for plans with less than $5 million in plan assets to 91 percent for plans with assets over $1 billion.[6] This percentage has been growing over time, rising from 62 percent in 2015.[7]

Why Have Target Date Funds Been the Most Dominant?

There are several reasons why target date funds are the most dominant QDIA. And, remember the ultimate purpose of the QDIA – namely to provide a default investment for those participants that do NOT make an active choice. These participants could be described as "reluctant investors" – those that do not have the time, desire, knowledge or experience to make an active choice.

The accompanying chart summarizes some of these reasons from the viewpoint of each stakeholder – participant, recordkeeper, fiduciary and target date fund manager.

Why Should Fiduciaries Revisit Their QDIA Selection Now?

Fifteen years is a long time! The PPA's QDIA regulations have provided a safe harbor to plan fiduciaries to select better investment defaults. Most plan sponsors selected target date funds as the QDIA. In general, these funds performed well during this economic time period – 2006

Stakeholder	Perspective
Participant	• Easy to understand – for participants who default, they are assigned to target date fund based on their expected retirement date. Comfortable – in general, employees trust their employer, so this trust extends to trusting the selected QDIA
Recordkeeper/Plan Administrator	• Simple methodology – use one data point – age – to select appropriate target date fund – and then execute a single trade • Easy to communicate to participants – "this is what happens if you do nothing"
Plan Fiduciary	• Complies with QDIA safe harbor • Known monitoring process – while more complicated than simply reviewing a single asset class fund, e.g., small cap value manager, fiduciaries can document a prudent process reviewing the glide path, underlying asset allocation, expenses, etc. to select a target date fund series • The "Sheep" effect – with the vast majority of other plans also selecting a target date fund series as their QDIA, fiduciaries may feel more comfortable with their selection
Target Date Fund Manager	• Three of the largest target date fund series (Fidelity, Vanguard and T. Rowe Price) leveraged their in-house recordkeeping and administration capabilities to gather tremendous assets. With this built-in access, these providers leapfrogged ahead of other target date fund managers – who have continued to play catch-up • Proprietary target date funds support the manager's overall business across multiple assets classes.

to 2022. So, why should plan fiduciaries reexamine this critical decision? Why spend the time and effort now?

In general, the number one reason is that plan fiduciaries need to make sure that they are comfortable with their choice today. That the selection of the QDIA is what will be best for participants now and in the future.

So, what is different now and why might a plan fiduciary choose a different QDIA – for example a managed account service? Why might TDFs not be the best QDIA option in a changing environment? Plan fiduciaries should be encouraged to consider these three factors as they look to find the best QDIA for their participants going forward.

1. Economic Outlook

- Most people would agree that it is reasonable to speculate that the investment landscape over the next 15 years will be vastly different from the last 15 years. Since the PPA passed in 2006, we have seen an incredible bull market that overcame the Great Financial Crisis of 2008 to roar ahead and experience some recent turbulence with COVID.
- Inflation, in particular, is vastly different than it was in 2006. As of the end of April 2022, the CPI-U unadjusted 12-month rate was 8.3 percent according to the Bureau of Labor and Statistics.[8]

2. Participant Diversity

- Target date funds use a single factor – age – to determine the appropriate asset allocation and are blind to other significant differentiators. Basically, this assumes that everyone who is the same age has the same investment needs and risk profile and therefore should have the same asset allocation. The major tradeoff in making this simplifying assumption is that the additional value by having a more customized asset allocation is not worth the additional cost to design and deliver this allocation. It ignores that other QDIAs like managed accounts can be cost-competitive with target date funds.
- Today, with advancements in technology, it is time to question this tradeoff of simplicity versus customization. The investment industry can provide more customized asset allocations using many more factors than simply age. Factors could include: account balance, pay, savings rate, sex, whether a participant has a defined benefit plan, out-of-plan assets like IRAs, and others. Participants, especially millennials and younger workers, demand a very customized experience in their digital lives – and expect the same experience in their retirement savings plan. Without it, many will choose non-traditional pathways to building retirement savings – and possibly forgo their employers' plans altogether.
- From a retirement readiness perspective, employees are all over the spectrum – from on-track to substantially off-track. Two 50-year-olds could be at opposite ends of this spectrum – one may have saved and invested well, so can take less investment risk, versus another who has a lot of debt and little savings and who needs to save and invest completely differently. A retirement savings plan may want to consider being able to handle these differences.

3. Transition to Decumulation

- If one thing is clear, the power of the QDIA to gather assets is undeniable. Whether this is from participants who completely default, i.e., did not make an active investment election, or simply participants who actively choose to invest in the QDIA, perhaps due to trusting that their employer did a proper job in selecting the QDIA in the first place.
- Combining this with the demographics of baby boomers retiring with larger and larger balances, plan fiduciaries may want to consider whether the QDIA is really best suited for their participants.
- Many critics of target date funds point to the fact that they take significant amount of investment risk and seek to maximize wealth rather than minimize retirement income volatility. Put another way, the risk profile of employees who are actively working and contributing to their retirement plan is significantly different than participants who are taking distributions and not contributing any further savings. Many target date funds have not yet attempted to bridge this gap.
- The Secure Act of 2019 included provisions to provide plan fiduciaries with a safe harbor when adding annuities within the plan. The enabling legislation has prompted new developments in products focused on QDIAs. These new offerings simply did not exist 15 years ago. Plan fiduciaries may want to consider the full spectrum of products at this time.

Summary

ERISA is clear about how plan fiduciaries should carry out their work – with the interest of participant and beneficiaries at the forefront, use a prudent process, make a choice, and then monitor ongoing performance. When it comes to selecting a plan's QDIA – perhaps the most visible and influential decision that plan fiduciaries make – one

cannot overemphasize this fiduciary duty. So much has changed since the PPA was passed – demographics, investment products, technology – that a full review of this choice seems warranted. With this review, plan fiduciaries should find the best solution for their plan participants for the next 15 years and beyond!

Notes

1. *www.lexico.com*.
2. Callan Institute, 2022 Defined Contribution Trends Survey, p. 45.
3. *https://www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/fact-sheets/final-rule-qdia-in-participant-directed-account-plans.pdf*.
4. *Ibid*.
5. *Ibid*.
6. *https://www.plansponsor.com/research/2021-dc-plan-benchmarking-survey/?pagesec=3#2021%20Survey*.
7. *Ibid*.
8. *https://www.bls.gov/news.release/cpi.nr0.htm*.

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