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DOL Investment Safe Harbor May Not Do Much for Retirement Income

The proposed rule does not give fiduciaries a 'stamp of approval' to innovate, one expert says.

Reported by EMILY BOYLE

The Department of Labor's proposed rule on selecting designated investment alternatives for retirement plans includes a safe harbor for fiduciaries choosing retirement income solutions. But experts say that may not mean much for uptake.

The proposal, published on March 31, offers a safe harbor that would allow retirement plan fiduciaries to meet their duty of prudence under the Employee Retirement Income Security Act when choosing investments for retirement plans. The safe harbor is available to plan fiduciaries that follow "a prudent process" in their selection. While the rule may commonly be referred to as the "alts rule" or the "alts proposal," lifetime income solutions may not traditionally be considered under the same umbrella as investments in infrastructure, digital assets or other alternatives mentioned within the rule.

"The proposal is meant to create a safe harbor, but it's not meant to change anything that's [already being done]," says Aliya Robinson, T. Rowe Price's director of congressional affairs. "It's meant to expand the written guidance, but not to change what's happening in practice."

What the Rule Does Not Do

Robinson says the DOL's proposed rule does not require additional work on the part of a plan sponsor. Rather, it provides a safe harbor for plans that would like to enjoy its protections.

Idan Shlesinger, a retirement solutions practice leader at October Three Consulting, says "everything [a fiduciary has] had to worry about before in terms of fiduciary obligations … applies in the exact same way whether [they're] dealing with a traditional investment or whether [they're] dealing with an alternative or income product."

The proposed rule is "investment-neutral," Robinson explains, echoing a sentiment expressed across the industry since it was proposed.

Jessica Sclafani, a retirement strategist leader for T. Rowe Price's global retirement strategy team, says lifetime income products are similar to private assets in that there is no prohibition on fiduciaries offering them today. However, adoption of lifetime income products has been limited due to fiduciaries' concerns about liability plan sponsors could face over selecting them.

Shlesinger says the proposed rule does not give fiduciaries a "get-out-of-jail free" card. Short of a "stamp of approval" against litigation from participants, however, he does not predict an increase in guaranteed lifetime income product uptake.

Josh Gotbaum, a former CEO of the Pension Benefit Guaranty Corporation, and a scholar in residence at the Brookings Institution's economic studies program, wrote in a comment letter in response to the proposed rule that the DOL's safe harbor could alleviate employers' fears of getting sued, but would not "by itself give [employers] a reason to do anything more or anything new." Gotbaum wrote that even without a fear of litigation, employers are "unlikely to undertake new initiatives unless they offer a clear benefit to a company and its employees."

Evaluating Lifetime Income Options

Kevin Walsh, a principal in Groom Law Group who advises clients on fiduciary matters, says the proposed rule is another step by regulators to encourage the industry to think about lifetime income products—and to address some of the perceived litigation risk that has "deterred innovation."

For fiduciaries seeking to fall within the safe harbor, the DOL proposal offers a six-factor test, covering the following aspects of investment selection: performance, fees, liquidity, valuation, benchmarking and complexity.

Walsh says the proposal's guidance could be problematic when evaluating guaranteed income products. First, thinking about what the proposed rule defines as the "risk-adjusted expected returns, net of fees and expenses," for evaluating investments may be an unusual way of judging the performance of a retirement income product, Walsh says. Therefore, he suggests an alternative way that plan sponsors could evaluate the performance of an annuity, an example of a guaranteed income solution.

Walsh says fiduciaries should ask themselves, "How much lifetime income will [participants'] premiums support?" He says fiduciaries can determine the rate of return an annuity can generate based on the amount of risk the fiduciary is comfortable pooling, as an example. The Insured Retirement Institute suggested in a comment letter that the DOL clarify that fiduciaries may consider additional relevant factors, including participant demographics, in determining a sponsor's prudence in selecting a particular investment product.

The DOL requested comments on whether the final rule should include an additional safe harbor element that considers individual participant profiles or characteristics. Organizations such as the IRI and the American Council of Life Insurers recommended the DOL not add a separate factor, but rather, address the concept more broadly in the context of harm, causation and class-wide proof in litigation analyses.

In evaluating fees, a fiduciary might consider that many lifetime income products do not have embedded fees, such as a mortality and expense charge on some variable annuities. Rather, the insurer often earns a spread between the yield on its investments and the rate it offers to the annuity holder, Walsh says.

Regarding the liquidity test, frameworks for evaluating a retirement income solution may vary by product structure, Walsh says. A fiduciary may select an annuity that is surrenderable only on specific terms—or it could select an annuity embedded into a target-date fund, in which the TDF provides full liquidity.

The IRI suggested in its comment letter that the DOL confirm that a product's liquidity be evaluated "in light of [its] purpose, including guarantees, insurance protections, longevity-risk transfer, income stability, downside protection, sequence-of-return risk mitigation and retirement income outcomes." The organization recommended the DOL clarify in its final rule that fiduciaries may compare products with lifetime income features against those without the features—but that comparison must account for the additional benefits of the former.

"Liquidity constraints should not, standing alone, make a product imprudent," the IRI stated. "The appropriate inquiry is whether the fiduciary has evaluated the product's liquidity characteristics in relation to … the value of the income-related benefits provided."

On valuation, Walsh explains that it is typically clear what a retirement income product, such as an annuity, is promising, making consideration of liquidity a less complex one for fiduciaries to consider. In addition, the proposed rule says it "emphasizes the importance of using a meaningful benchmark as a factor when selecting designated investment alternatives." For the purposes of the proposal, a "meaningful benchmark" is defined as "an investment, strategy, index, or other comparator that has similar mandates, strategies, objectives, and risks to the designated investment alternative."

The IRI letter stated that "traditional benchmarks" focused on account balance growth, risk-adjusted returns, volatility or historical performance may be insufficient for evaluating products designed to generate protected income. The IRI suggested that the DOL clarify in its final rule that fiduciaries should "benchmark lifetime income products using measures that reflect their income-generating purpose, rather than relying solely on traditional accumulation metrics."

The IRI also called for a benchmark comparison that would account for the presence or absence of guarantees and risk management features, rather than treating all products as directly comparable on return metrics.

Complexity, the final factor, comes down to whether fiduciaries "understand the product," Walsh says. "If [a product's] complexity isn't warranted, you [would] expect it to get knocked out [here first]."

Gotbaum wrote in his letter that evaluating complexity calls for "heightened diligence" and "expert engagement for structurally novel products." He said annuities with guaranteed withdrawal benefits, deferred income annuities embedded in TDFs and managed accounts with insurance components are "materially more complex than index funds."

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