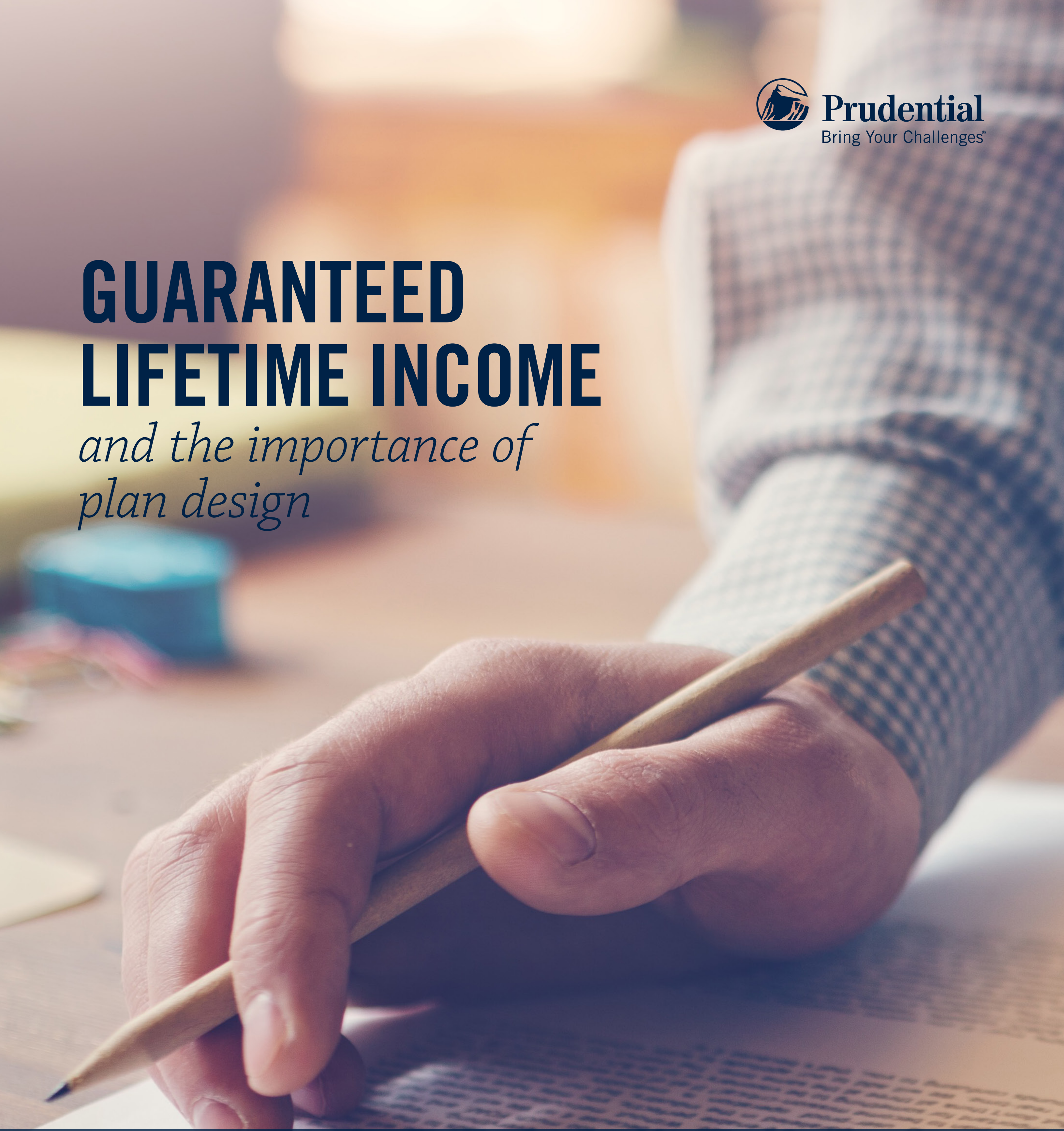

GUARANTEED LIFETIME INCOME

and the importance of plan design

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INTRODUCTION

American workers face serious challenges in preparing for a secure retirement. The challenges come in multiple forms—market volatility, increasing life expectancy, and even their own thinking and behavior. Combined, they can result in retirement outcomes that don't achieve basic objectives. For example, a third of the population are below average or failing when it comes to retirement planning, yet among a list of financial priorities, "not running out of money in retirement" ranks as the most important item.[1]

A 2014 Prudential Retirement® financial literacy and retirement readiness study found that most employees are falling short in saving what they need for retirement, with 36% not saving at all.[1] The study suggests that there is a compelling need for retirement plans to do more to bridge the gap between financial literacy and retirement readiness.

Further, we know that workplace retirement plan sponsors are experiencing related challenges of their own.

We have explored these challenges—including what is driving them and their impact on defined contribution (DC) retirement plans—in two earlier thought leadership reports.

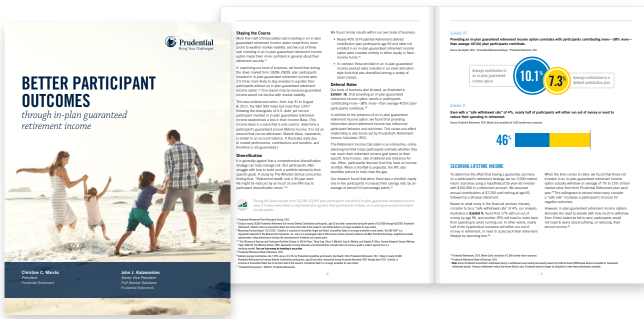
What Employers Lose in the Shift from Defined Benefit to Defined Contribution Plans…and How to Get It Back[2] examines the workforce management challenges posed by increased reliance on DC plans from a plan sponsor's point of view.

[1] Prudential Retirement, *Financial Literacy and Retirement Readiness Study*, 2014.

[2] Originally published 2011.

It also demonstrates through a hypothetical case study how a lifetime income solution can help participants retire on time, improve their quality of life during retirement and ensure that they will never run out of money in retirement.

In *Better Participant Outcomes Through In-Plan Guaranteed Retirement Income*,[3] we look at the direct and indirect effects of a lifetime income solution on participants. The paper goes beyond the hypothetical to communicate what we learned from two proprietary research studies focusing on real plans and real participants.



The analysis finds that when lifetime income options are added to DC plans:

- Participant satisfaction increases
- Participant confidence increases
- Participant outcomes improve due to better long-term investing behaviors

We found that participants with lifetime income options were more inclined to stay invested during market turmoil, were better diversified and contributed more than those without.

In this current paper, the third of our series on lifetime income, we discuss the pivotal role that plan design plays in unlocking the full potential of lifetime income solutions. Our insight was derived from actual plan experience to see how different mixes of plan design features drive the chances for producing the best participant outcomes.

Central to this analysis is an examination of the impact that a plan default investment with a lifetime income benefit has on participant behaviors and outcomes. Our findings provide insight on how starting participants off with a default investment combined with lifetime income can help support two key plan design features:

- Automatic enrollment
- Automatic contribution escalation

Our analysis shapes what we believe product providers, intermediaries and plan sponsors should be considering to help American workers save and invest for their Day One of retirement. Before reviewing the results, it is important to understand the specifics of the guaranteed lifetime income benefit that is referenced in our research. The "Clarification Note" sidebar on this page defines Prudential IncomeFlex®, the product studied in our analysis. Later in this paper, additional Clarification Notes will provide similar explanations of other terms being referenced.

Clarification Note:

Prudential IncomeFlex is a guaranteed lifetime retirement income benefit that provides investors sustained potential for growth, downside protection for retirement income, guaranteed income that they cannot outlive,[4] and complete access to their market value.[5] IncomeFlex can be combined with a wide range of underlying investments and investment programs including target-date funds, interactive asset allocation programs, custom balanced portfolios, and managed accounts.

Latest Research-Based Learnings

This paper references a proprietary Prudential Retirement research study:

2014 Total Retirement Solutions Book of Business Analysis—This study looked at outcomes based on a plan's decision to utilize a default investment that includes a guaranteed lifetime income solution. The study tracked more than 1,900 DC plans (more than 2 million plan participants) administered by Prudential Retirement from December 31, 2008 to December 31, 2013. It centered on the impact that Prudential IncomeFlex (when used with a plan default investment) has had on participant behaviors and outcomes, and how starting participants off with a lifetime income investment option supports the benefits generated by automatic enrollment and automatic contribution escalation.

[3] Originally published 2012.

[4] Withdrawals or transfers (other than transfers between IncomeFlex Target Portfolios) proportionately reduce guaranteed values prior to locking-in. After lock-in, withdrawals in excess of the lifetime annual withdrawal amount will reduce future guaranteed withdrawals proportionately and may even eliminate them entirely.

[5] Guarantees are based on the claims-paying ability of **Prudential Retirement Insurance and Annuity Company, Hartford, CT,** and are subject to limitations, terms, and conditions.

BUILDING STRONGER PLAN PARTICIPATION

A Best Case Scenario for Raising Participation Rates

At Prudential Retirement, we firmly believe that automatic enrollment features for all plan members can help put more Americans on the path to a financially secure retirement. Our goal is to help intermediaries and plan sponsors optimize plan design to produce the best possible outcomes for participants. To that end, we also believe that employing a plan default investment that includes a guaranteed lifetime income benefit can help accentuate this advantage.

Our previous research has shown that the introduction of in-plan guaranteed retirement income options can make participants feel more prepared for retirement and produce better retirement outcomes.[6] In order for this to be the case, however, employees must first *participate* in their DC plan.

Today, automatic enrollment has become more prevalent than it was even 10 years ago—largely due to the passage of the Pension Protection Act of 2006 and the establishment of Qualified Default Investment Alternatives (QDIAs)—and it has inarguably contributed to a rise in the number of DC plan participants. For example, in 2013, 59% of 401(k) plans used auto-enrollment,[7] as opposed to just 19% in 2005.[8]

Despite this increase in participation, the work of preparing Americans for a secure retirement is not done. Plan sponsors still need to focus on designing and managing their plans to best benefit their employees and organizations.

So, what is the *best case* scenario, the one in which the highest number of participants are enrolled in their DC plan? In our study, participation rates were highest when automatic enrollment was combined with a default investment with IncomeFlex.

Using a default investment with built-in lifetime income benefits can help overcome some of the traditional barriers to adoption that guaranteed retirement income options have faced, like lack of awareness of benefit availability and perceived complexity. They also allow participants to experience the solution's multiple benefits (as discussed in the introduction).

Clarification Note:

Automatic enrollment is a plan design feature that can be implemented in various ways, including automatically enrolling newly eligible workers (while offering them the ability to opt-out), as well as enrollment events for all eligible workers.

Looking specifically at IncomeFlex in our book of business, our analysis demonstrates the power of plan design to raise participation rates.

As the exhibit shows, when workers are left to their own devices in a plan without a guaranteed lifetime income benefit, the participation rate is 65%. While adding IncomeFlex to a plan's investment line up improves the participation outcome, the highest rate is achieved by combining IncomeFlex with a default investment within an automatic enrollment feature.

Automating much of the participation process can also reduce costs and simplify decision-making for the employer.[9]

[6] Prudential Retirement, 2012, *Better Participant Outcomes Through In-Plan Guaranteed Retirement Income.*

[7] Aon Hewitt, 2013, *Trends and Experience in Defined Contribution Plans.*

[8] Aon Hewitt, 2011, *Hot Topics in Retirement and Trends and Experience in 401(k) Plan Surveys.*

[9] Prudential Retirement, 2009, *Redefining Defined Contribution Plans to Enhance Retirement Security.*

What about Opt-Outs?

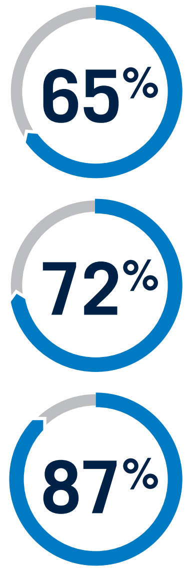
Though some in the marketplace have had concerns that adding an in-plan guaranteed retirement solution could increase the opt-out rate, our study showed that the reverse is actually true: When IncomeFlex is added, there is a nearly 3% reduction in opt-outs.[10]

Clarification Note:

Our analysis examined participation rates from both a participant-weighted and a plan-weighted viewpoint. A participant-weighted average assigns plans with a larger number of participants more weight than plans with a smaller number of participants. A plan-weighted average assigns plans with a smaller number of participants the same weight as plans with a larger number of participants. This paper references plan-weighted rates, which smooth out results and tend to reduce the statistical influence of larger plans on smaller plans.

In addition to benefiting participants, a well-designed DC plan with a built-in guaranteed retirement income option provides the sponsor with built-in risk protection that can help mitigate fiduciary risk during market downturns.[9]

Plan Participation Grows by 34%



Plans without IncomeFlex

Plans with IncomeFlex

Plans with Automatic Enrollment and a Default Investment with IncomeFlex

Rule of Thumb

Across all plan design groupings, plans with IncomeFlex generally have higher participation rates than those without. According to our research, the optimal design for the best participation was a plan with a default investment with IncomeFlex, automatic enrollment (for all plan eligible workers), and participant automatic contribution escalation (for all plan members), resulting in an ***88%*** *participation rate.*

[10] 7.5% versus 7.7%.

DRIVING HIGHER PARTICIPANT ACCOUNT CONTRIBUTIONS

Contribution rates are another plan-level statistic (along with participation rates) that can be looked at as a plan health vital sign. While robust participation rates are one key driver of DC plan health, plan sponsors also show concern about workers having enough savings to generate sufficient retirement income. In one study, for example, 58% of DC-only plan sponsors believed their workers would reach retirement age without enough savings to generate sufficient retirement income.[11]

Contribution rates are especially important because the DC plan has increasingly become the main source of retirement income for Americans, although they were initially designed to serve as supplemental savings plans.

The Facts about Plan Design and Contributions

The good news is that a well-designed plan can help alleviate the concern over contribution rates—particularly the use of automatic features. According to Cogent Research, automatic features can play a large role in getting participants to save more, and our research also bears out that thinking.[12]

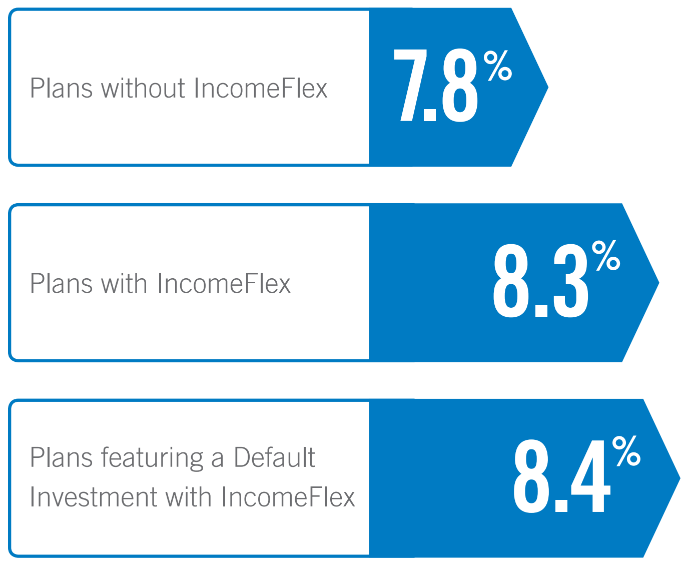
Before we delve deeper into our results, it's important to understand how automatic enrollment features can impact contribution rate averages. The default contribution rates built into many automatic enrollment features[13] are often lower than the average contribution rates of participants who actively elect to join their plan. As such, automatic enrollment may drop average contribution rates even as it raises participation rates.

In order to filter out these effects and focus in on how a plan's decision to utilize a default investment with IncomeFlex impacts contribution rates at a deeper level, we looked at only "non-automatic enrollment participants" within our book of business.

Our analysis demonstrates the power of plan design to accelerate a plan's average participant contribution rate.

Although the difference in average contribution rate between plans with IncomeFlex versus plans with a default investment with IncomeFlex is relatively small, the difference for participants could be huge. For example, offering a default investment with an in-plan guaranteed retirement income solution eliminates the risk that participants could pass up the opportunity for a lifetime income stream simply because they weren't aware it was available.

Contribution Rate Rises by 7.7%



[11] MetLife Qualified Retirement Plan Barometer 2014.

[12] Fund Action Newsletter, Vol. XXV, No. I, 2014, *DC Managers Focused on Income, Customization.*

[13] More than **80%** of the plans in our book of business analysis set their automatic enrollment feature's contribution rate default at **3%** or less.

When combined with automatic contribution escalation, the impact is even greater. Between 2010 and 2013, participants in plans without IncomeFlex, but with auto-escalation, saw their average contribution rate grow from 4.6% to 6.7%—**46%** growth. At the same time, participants in plans with auto-escalation and a default investment with IncomeFlex saw their average contribution rate grow from 4.4% to 7.0%—**59%** growth.

Clarification Note:

Automatic contribution escalation is a plan design feature that may be offered as a participant-elected option or set up as a systematic default for all new plan members (while offering them the ability to opt-out).

These findings are good news for plan sponsors and participants in light of the fact that nearly half of DC plan sponsors have "increasing participants' savings rates" as number one or two on their priority list, according to a 2012 survey from the Defined Contribution Institutional Investment Association (DCIIA). In addition, the DCIIA believes that "automatic contribution escalation may be the most powerful tool plan sponsors have to help participants save more."[14]

Providing an auto-escalation option combined with auto-enrollment and a default investment with an in-plan guaranteed retirement income solution may be one of the most important steps you can take to help your participants prepare for a successful retirement.

Rule of Thumb

Across all plan design groupings, plans with IncomeFlex, on average, have higher contribution rates than those without.

[14] Defined Contribution Institutional Investment Association, *Plan Sponsor Survey 2012: Action Needed to Drive Better Participant Outcomes.*

IMPACTING PARTICIPANT ACCOUNT DIVERSIFICATION

Plan Design that Guards Against Inadequate Asset Allocation

We know that a diversified asset allocation mix is a significant factor in DC plan outcomes. As such, providing participants with investment guardrails to help protect them from the risks posed by inadequate diversification can drive better outcomes.

We can look at diversification rates that show the percentage of participants who are allocated 100% in either equity or fixed income investment funds as another plan-level statistic (along with participation rates and contribution percentages) that can indicate plan health.

When we focus on this aspect of our book of business, our analysis demonstrates the power of plan design to:

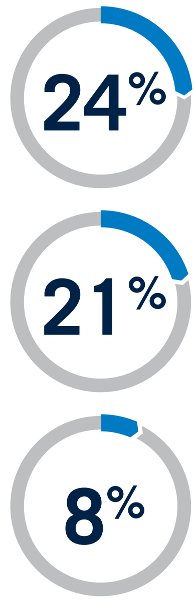
- Help more plan participants realize the importance of asset allocation
- Minimize a plan's average percentage of participants who are invested 100% in either equity or fixed income

Clarification Note:

GoalMaker® is an interactive asset allocation program available at no extra cost. The program can identify a model portfolio that corresponds to a participant's retirement goals using the investment options offered through the retirement plan.

These findings contribute to the case for employing a plan investment default with lifetime income benefits versus more traditional asset allocation options (including asset allocation programs or target-date funds that are not paired with lifetime income benefits).

Non-diversified Investors Reduced by 67%*



Plans without IncomeFlex

Plans with IncomeFlex

Plans with Automatic Enrollment and a Default Investment with IncomeFlex

Rule of Thumb

In head-to-head comparisons over time of plans with automatic enrollment, plans with an investment default with IncomeFlex have a much lower instance of participants being invested 100% in either equity or fixed income than plans with GoalMaker (without IncomeFlex) as their investment default.

*Percentages represent participants who have opted out of the QDIA.

SUMMARY AND CONCLUSION

As the percentage of workers with defined benefit (DB) plans declines, many Americans continue to lose a critical element of their retirement security: guaranteed lifetime income.

Through our research, we want to continually find the best ways to address this and other challenges and help drive the most favorable results possible in today's DC plans.

Our earlier research relayed how the introduction of in-plan guaranteed retirement income options:

- Made participants feel more prepared for retirement
- Produced better retirement outcomes

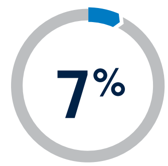
Our recent findings go a step further and support our hypothesis that incorporating an in-plan guaranteed lifetime income solution within a plan's default investment can—when combined with auto-enrollment and auto-contribution escalation—lead to American workers adopting even more beneficial behaviors with regard to:

- Plan participation
- Participant contributions
- Personal account diversification

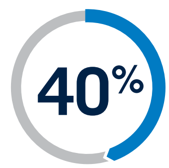
This recent analysis demonstrates how plan design is key to unlocking the full potential of lifetime income solutions.

There is growing attention being paid to the value of insuring against market volatility risk in the years preceding retirement and against longevity risk during retirement. But, if a plan is not set up to drive a significant portion of its assets into the "protected" category, the ability to impact outcomes is limited.

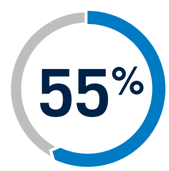
As the following data shows, the percentage of participants with covered assets can be 8 times greater based upon plan design.



Plans that add IncomeFlex*



Plans that add IncomeFlex with their Default Investment*



Plans that add IncomeFlex with their Default Investment and Automatic Enrollment*

*GoalMaker is the default investment and percentages are participant-weighted.

Clarification Note:

Covered assets include assets on the path to having IncomeFlex benefits activated plus assets under management where the IncomeFlex benefit is active. Generally, activation takes place as workers approach retirement—when market declines can have a huge impact. For target-date funds, this is 10 years prior to a fund's stated target date. For GoalMaker, this is when a participant reaches age 55.

As discussed earlier, measures must be taken to close the retirement readiness gap. Optimizing plan design, as outlined in this report, is one way to help get there, but we have a long way to go before it is widespread. The Society of Actuaries, in a 2013 report, suggests that this may be because the majority of plan sponsors still view DC plans as savings vehicles rather than retirement income vehicles (91% vs. 9%).[15]

[15] The Society of Actuaries, 2013, The Next Evolution in Defined Contribution Retirement Plan Design.

The Pursuit of Better Tools to Build Retirement Security

DB plans once provided many Americans with what they needed in a retirement income source: certainty. To step up to this important challenge, today's workplace retirement plans need fundamental structures that support workers by doing the following:

- Starting them saving and investing as soon as possible for the purpose of generating future retirement income.
- Starting them off with an investment option that delivers appropriate diversification and offers guardrails against behaviors that can take them off track.
- Providing a mechanism to increase their base for guaranteed retirement income as their earnings grow.

In our opinion, this is the definitive formula for transforming America's retirement industry for the betterment of all, taking American workers from their Day One of employment to their Day One of retirement with confidence.

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