

A Cautionary Tale: The Economic Crisis and Your Company's DC Plan

Three Simple Suggestions to Help Pre-Retirees Secure Income Base Earlier

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It's an unavoidable and well-documented development: chief financial officers, chief risk officers and chief investment officers are becoming increasingly responsible for the design, performance and maintenance of their company's defined contribution and defined benefit plans.

It's a fact of corporate and non-profit organizational life that is complicating an already overcrowded daily calendar for these finance and investment professionals. So, in addition to addressing the severe balance-sheet distress that the current economic crisis is causing businesses and organizations all across America, CFOs are also being charged with helping to fix the damage being done to pre-retirees' account balances—the front page news that is often dramatically and sensationally referred to as the reduction from a healthy “401(k)” to a wholly inadequate “201(k).”¹

Seven Trillion Dollars Pulls a Vanishing Act; Retirees and Older Workers Suffer

Even the most cursory examination of the business news brings home the startling facts about the current bear market and the larger subprime mortgage problem that helped inspire it.

As Alicia H. Munnell, director of the Center for Retirement Research at Boston College, observed in a recent newspaper article, *Retirees Filling the Front Line in Market Fears*, “There's a terrified older population out there. If you're 45 and the market goes down, it bothers you, but it comes back. But if you're retired or about to retire, you might have to sell assets before they have a chance to recover ... and people don't have the luxury of being in bonds because they don't yield enough for how long we live.”²

Step 1: Change the Rules to Accommodate New Plan Realities

Answering a charge of inconsistency, John Maynard Keynes, the renowned economist, famously replied: “When the facts change, I change my mind. What do you do sir?” One arena in which the

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facts have clearly changed is workplace retirement plans. Defined contribution programs used to be supplements to robust defined benefit pensions. Let's not forget that these DC “savings plans” were intended to give employees a tax break to put away “a little extra” so they could spice up their golden years. Today, DC plans like 401(k)s and 403(b)s are becoming the primary source of retirement income for more and more Americans. They are being asked—even required—to deliver a benefit they were never intended to produce.

Fortunately, academics, government policy makers and retirement plan fiduciaries have begun taking steps to help bridge the gap

between retirement realities and the retirement that Americans want and need. The key concept underlying these efforts is what I like to describe as “putting inertia on the side of angels.” Others, such as Richard H. Thaler and Cass R. Sunstein, pointing to the lessons of behavioral finance and the importance of retaining freedom of choice, prefer the term “libertarian paternalism.”³ Whatever term you apply, it's all about automatically placing people on a path to better retirement outcomes with: automatic enrollment; contribution escalation; and appropriate asset allocation (with the QDIA regulation as a guide). All of these steps were codified in the Pension Protection Act (PPA) of 2006 and its enabling regulations. According to the Retirement Security Project, the PPA has encouraged steady increases in both automatic enrollment and contribution escalation programs,⁴ with new contributions headed toward target-date funds in record numbers.

It's great news. And it certainly helps get people to the point of retirement. But then what? The game changes again. If your plan design encourages self-destructive cash-outs and inadequate income arrangements, all your good work on the accumulation side can go for naught. And this new risk needs to be addressed with new solutions.

Step 2: With Endgame in Sight, Help Protect Accumulated Wealth

The traditional tool to address income and longevity needs is an annuity. Annuities do a wonderful job of pooling mortality risk and offering individual guaranteed, lifetime income. But rightly or wrongly, traditional annuities have not been perceived favorably among the general public. Among their supposed sins are a lack of flexibility, high fees and loss of control once annuity payments begin.

Providers like Prudential Retirement have recognized the need for innovative solutions that address these concerns. Our offering, Prudential IncomeFlex®, is designed to integrate smoothly into a DC plan's lineup. It combines the disciplined, professionally managed investments envisioned by the QDIA regulation with the flexibility and control individuals demand ... and with Prudential's guarantee of a steady income for as long as the participant lives.

Because IncomeFlex offers a guaranteed minimum withdrawal benefit (GMWB) rather than a stream of annuity payments, participants retain the ability to withdraw more or less than their guaranteed amount, or to walk away with their market values at any time. They're also protected from market downturns and retain the ability to take advantage of a market recovery.

Step 3: Adopt In-Plan Income Solution with Downside Protection, Upside Potential

Predictably, the current economic crisis is resulting in the worst possible behaviors on the part of ill-informed plan

“The Economics of Despair”

- Approximately \$7 trillion in shareholder value has been wiped out.⁵
- This bear market is already deeper and more damaging than most of the 10 bear markets since the 1930s.⁶
- According to a survey conducted by CFO Europe magazine, pessimists among American CFOs currently outnumber optimists nine to one.⁷
- The World Bank’s “Global Economic Prospects” report predicts trade volume will decline nearly three percent in 2009 and that the global economy will expand by less than one percent.

participants. According to a recent AARP survey, 20 percent of Baby Boomers said they had stopped contributing to their retirement plans, 34 percent said they were thinking of delaying retirement, and 27 percent reported problems handling such basic expenses like rent and mortgage payments. Similarly, the Congressional Budget Office reported in October that the nation’s pensions and 401(k) plans had lost around \$2 trillion over the previous 15 months, with many 401(k) plans losing 20 percent or more of their value.

Even without the perfect economic storm we are currently weathering, we were running the risk of having a whole generation of retirees entirely unprepared for the financial demands of retirement. Sadly, the problem has now been outlined with sharper definition.

To combat this growing trend, we need to implement in-plan income solutions that either use a default or encourage participants to transfer their accumulated wealth into a GMWB, thus protecting account balances during the critical pre-retiree and post-retiree years. Many providers have entered the market, and others are reported to be on their way. Independent consultants and advisors will be critical contributors in helping plan fiduciaries evaluate and select the solution that makes the most sense for their plans.

The advantages are clear and compelling:

- Participants are able to address longevity risk with a greater exposure to equity upside because they have downside protection.
- As investment options, in-plan solutions complement the DC process to which participants have grown accustomed.
- A GMWB provides exactly what your organization seeks to provide in offering a DC plan—a retirement paycheck for life.

Heed the Warning, Solve for the Future

Like every change in the business climate, the current economic crisis can be viewed as an opportunity—one in which we can engage the shortcomings of DC plans actively, constructively and imaginatively.

We owe it to everyone involved—participants, sponsors and



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advisors—to heed the lessons of this cautionary tale and ensure that the current economic crisis becomes a defining moment in the progressive evolution of the defined contribution plan.

- ¹ “Retirement Becomes a More Distant Prospect for Many Approaching 65”, New York Times, October 23, 2008, Steven Greenhouse, Business/Retirement.
- ² “Retirees Filling the Front Line in Market Fears”, New York Times, September 22, 2008, John Leland and Louis Uchitelle.
- ³ Richard H. Thaler and Cass R. Sunstein, “Libertarian Paternalism”, The American Economic Review, Vol. 93, No. 2 (May, 2003).
- ⁴ “The Automatic 401(k): Enhancing Retirement Security for America’s Workers”, The Retirement Security Project, Washington, D.C., 2007.
- ⁵ “No End in Sight for Year-Old Bear Market”, The San Diego Union Tribune, Associated Press, October 9, 2008, Dave Carpenter.
- ⁶ Ibid.
- ⁷ Kate O’Sullivan, “Business Outlook Survey: Rock Bottom”, CFO.com, December 10, 2008 (<http://www.cfo.com/article.cfm/12757684?>).

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IncomeFlex guarantees are based on the claims-paying ability of the insurance company and are subject to certain limitations, terms and conditions. To maintain the IncomeFlex benefit, you must invest in one or more Prudential IncomeFlex Funds. Like all variable investments, these funds may lose value. Guaranteed growth of the income base ends at age 70 or when guaranteed withdrawals begin, whichever is earlier. Withdrawals in excess of the guaranteed lifetime income amount will reduce future guaranteed withdrawals proportionately.

Prudential IncomeFlex funds are investment options available under group variable annuity contracts issued by Prudential Retirement Insurance and Annuity Company (PRIAC). PRIAC does not provide any guarantee of the investment performance or return of contributions to those separate accounts. PRIAC’s guarantee of certain withdrawals is supported by PRIAC’s general account and is contingent on its claims paying ability. Guarantees are subject to certain limitations, terms, and conditions. You should consider the objectives, risks, charges, and expenses of the funds and guarantee features before purchasing this product. You should carefully review the Prudential IncomeFlex Important Considerations before purchasing this product. Product availability and terms may vary by jurisdiction. Subject to regulatory approvals. Contract form number GA-2020-IFGW2-0805 or state variations thereof.

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