DEFINED CONTRIBUTION PLANS
12 Practical Recommendations to Help Encourage Better Outcomes

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# Table of Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td>1</td>
</tr>
<tr>
<td>Challenges</td>
<td>2</td>
</tr>
<tr>
<td><strong>Best Practices: Building Blocks for Effective Solutions</strong></td>
<td>5</td>
</tr>
<tr>
<td>Automatic Enrollment</td>
<td>6</td>
</tr>
<tr>
<td>Default Savings Rate</td>
<td>9</td>
</tr>
<tr>
<td>Asset Allocation</td>
<td>10</td>
</tr>
<tr>
<td>Automatic Contribution Increase</td>
<td>10</td>
</tr>
<tr>
<td>Encouraging Comprehensive Planning</td>
<td>11</td>
</tr>
<tr>
<td>The Ultimate Goal: Lifetime Income</td>
<td>11</td>
</tr>
<tr>
<td><strong>Recent Legislation Encourages Solution-Oriented Design Changes</strong></td>
<td>12</td>
</tr>
<tr>
<td>“Autopilot” Features</td>
<td>13</td>
</tr>
<tr>
<td>Guaranteed Lifetime Income</td>
<td>13</td>
</tr>
<tr>
<td>Investment Advice</td>
<td>13</td>
</tr>
<tr>
<td><strong>Conclusion</strong></td>
<td>14</td>
</tr>
</tbody>
</table>
Introduction

According to the Center for Retirement Research (CRR) at Boston College, the greatest private-sector factor behind the negative trend seen in its National Retirement Risk Index (NRRI) over the past quarter century is the ongoing shift in the composition of pension coverage from Defined Benefit (DB) to Defined Contribution (DC) plans. (The NRRI measures the percentage of working-age households who are at risk of being unable to maintain their pre-retirement standard of living in retirement.) In 1983, 62 percent of U.S. workers with pension coverage were enrolled in DB plans only, while 12 percent participated only in 401(k) plans, the most common type of DC plan. By 2004, that trend had reversed itself and then some, with 63 percent of workers enrolled in 401(k) plans and just 20 percent in DB plans. (The number of workers covered by both types of plans declined from 26 percent in 1983 to 17 percent in 2004.)

This large-scale transfer of retirement risk from organizations to individuals has accelerated since 2004 with an increase in the number of sponsor organizations freezing or terminating pensions, and it is expected to continue. Among the factors driving this trend are the desire of sponsoring organizations to cut compensation costs, their response to steadily increasing health-care costs, their concern about the impact of defined benefit plans on earnings, and the emergence of two-tier pension systems at many organizations.
Despite the shift from DB to DC plans, overall pension coverage has remained about the same in terms of the percentage of workers participating. The most significant impact of the shift has been a decline in the level of future benefits projected for workers covered by Defined Contribution plans. However, that projected shortfall does not stem from a structural weakness in DC plans vis-à-vis DB plans; in theory, participants could do equally well under either type of plan.\(^3\)
The discrepancy is due primarily to behavioral factors and is reflective of a broader societal problem—as a nation, we simply are not saving enough. Over the past two decades, U.S. workers’ retirement prospects have become increasingly insecure. The percentage of households deemed at risk of being unable to maintain their current standard of living in retirement rose sharply, from 31 percent in 1983 to 43 percent by 2004, and it continues to worsen. The U.S. personal savings rate, which averaged about 2 percent during the first five years of the current decade, turned negative—meaning households were spending more than they earned—in the second quarter of 2005 and remained that way through all of 2006.

Troubling attitudes toward saving are reflected in DC retirement plans in a number of ways. Among workers with access to a DC retirement plan in 2006, more than one in five (21 percent) chose not to participate at all. Employees who do participate tend not to save enough and not to increase their rate of saving over time. Less than 10 percent of 401(k) participants make the maximum allowable annual contribution to their plans. Less than 17 percent increased their contribution rates in 2005, while almost 10 percent decreased their savings rate.

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The portfolios of more than half of 401(k) participants lack proper diversification. On average, participants have more than 10 distinct investment options from which to choose, but fewer than three are represented in their portfolios. In addition, many portfolios are over-weighted with stock of the participant’s employer, and that problem is most significant among large 401(k) plans (5,000 or more participants).

Improper use of DC plans is another area of concern. Almost one in five participants in plans that allowed borrowing against account balances had loans outstanding in 2005, with the amount borrowed representing an average of 13 percent of the remaining account balance at year-end 2005. More than 40 percent of 401(k) plan distributions are taken in cash rather than being rolled over directly into another qualified retirement savings account such as an IRA, according to the Federal Reserve Board, and up to 20 percent of job-changers deplete their account balances when leaving their former employer, despite having to pay tax and penalties on the money withdrawn.

The ultimate objective of any retirement plan is to provide a reliable stream of income to participants in their retirement years. Traditionally, retirement strategies have been based on three resources—Social Security, pensions, and personal savings—with the first two considered “guaranteed” sources of lifetime income. However, with the displacement of DB plans by DC plans, the pension element has become a less secure source of guaranteed lifetime income. The challenge to plan sponsors is in finding ways to make their DC plans do a better job of filling that role.

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The 16th annual Retirement Confidence Survey (RCS) conducted by the Employee Benefit Research Institute (EBRI) underlines an unsettling truth for many future retirees. There is a jarring disconnection between their vision of the future and the reality of the lifestyle their current retirement planning and savings practices will allow them to afford. The 2006 RCS suggests that “…many American workers are not ready to undertake the task of financial planning for their retirement and face the prospect of having to work far longer than they expect.” It also concludes that Americans have opinions and exhibit behaviors that hinder their ability to realistically assess the preparation needed to ensure a financially secure retirement.
Employer-sponsored plans already play an important role in encouraging workers to save for retirement, EBRI reports, but they need to do more to help workers secure a comfortable retirement. Prudential Retirement believes that plan sponsors can best contribute to that effort by designing DC plans in ways that leverage consumer financial behavior to offset current deficiencies. Behavioral research has demonstrated that workers tend to follow the retirement planning path of least resistance. As a result, plan sponsors and service providers are in a critical position to develop and improve that path when designing or redesigning a DC plan—particularly when it comes to establishing the plan’s default provisions. Prudential Retirement considers the following best practices to be the essential basic building blocks for any DC plan.

### Automatic Enrollment

Even before the enactment of the Pension Protection Act of 2006 (PPA)—with its provisions encouraging companies to automatically enroll eligible employees in DC plans—adoption of this practice was on the rise. The percentage of plans with automatic enrollment more than doubled in just two years, climbing from 8.4 percent in 2003 to 16.9 percent in 2005, according to the most recent survey conducted by the Profit Sharing/401(k) Council of America (PSCA).

#### The Effects of Automatic Enrollment on 401(k) Participants

<table>
<thead>
<tr>
<th></th>
<th>Automatic Enrollment</th>
<th>Participation rate before automatic enrollment</th>
<th>Participation rate after automatic enrollment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td></td>
<td>37.4%</td>
<td>85.9%</td>
</tr>
<tr>
<td>Gender</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Male</td>
<td></td>
<td>42.3%</td>
<td>85.7%</td>
</tr>
<tr>
<td>Female</td>
<td></td>
<td>35.9%</td>
<td>86.0%</td>
</tr>
<tr>
<td>Age</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&lt;20</td>
<td></td>
<td>–</td>
<td>73.6%</td>
</tr>
<tr>
<td>20-29</td>
<td></td>
<td>25.3%</td>
<td>82.7%</td>
</tr>
<tr>
<td>30-39</td>
<td></td>
<td>37.2%</td>
<td>86.3%</td>
</tr>
<tr>
<td>40-49</td>
<td></td>
<td>47.3%</td>
<td>90.1%</td>
</tr>
<tr>
<td>50-59</td>
<td></td>
<td>51.8%</td>
<td>90.0%</td>
</tr>
<tr>
<td>60-64</td>
<td></td>
<td>60.0%</td>
<td>86.0%</td>
</tr>
<tr>
<td>Compensation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&lt;$20,000</td>
<td></td>
<td>12.5%</td>
<td>79.5%</td>
</tr>
<tr>
<td>$20,000-29,999</td>
<td></td>
<td>24.5%</td>
<td>82.8%</td>
</tr>
<tr>
<td>$30,000-39,999</td>
<td></td>
<td>42.2%</td>
<td>88.9%</td>
</tr>
<tr>
<td>$40,000-49,999</td>
<td></td>
<td>51.0%</td>
<td>91.8%</td>
</tr>
<tr>
<td>$50,000-59,999</td>
<td></td>
<td>61.6%</td>
<td>92.8%</td>
</tr>
<tr>
<td>$60,000-69,999</td>
<td></td>
<td>59.7%</td>
<td>94.7%</td>
</tr>
<tr>
<td>$70,000-79,999</td>
<td></td>
<td>57.9%</td>
<td>91.5%</td>
</tr>
<tr>
<td>$80,000+</td>
<td></td>
<td>68.3%</td>
<td>94.2%</td>
</tr>
</tbody>
</table>


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The practice has been most widely embraced among larger employers, with almost a third of plans with 5,000 or more participants now featuring it. But it continues to grow among plans of all sizes, including very small plans with fewer than 50 members.

Automatic enrollment has the effect of reversing the impact of one of the greatest behavioral impediments to more effective retirement saving: inertia. When employees are required to take action, such as filling out paperwork in order to enroll in a DC plan, a certain percentage of any given population simply won’t bother to do so. Automatic enrollment imposes the same kind of action requirement on new employees in order to opt out of participating in the sponsoring organization’s retirement plan, thus leveraging inertia to support increased levels of participation. Research also suggests that continued participation rates at plans with automatic enrollment are higher than the industry average.  

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**Older vs. Younger Worker Reaction to Automatic Enrollment into a Retirement-Savings Plan**

*Older workers:* “Given your experience, how would you feel today if—over the last 30 years—the organizations you had worked for had automatically enrolled you in your workplace retirement program, rather than leaving it up to you?”

- Resentful: 6%
- Apprehensive: 11%
- Don’t know: 8%
- Optimistic: 35%
- Grateful: 40%

*Younger workers:* “If you changed jobs today and the new workplace retirement savings plan automatically enrolled you, how would you feel about it over the more traditional do-it-yourself approach?”

- Resentful: 7%
- Apprehensive: 21%
- Don’t know: 6%
- Optimistic: 41%
- Grateful: 25%

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**Favorability Toward Automatic Features of Employer-Sponsored Plans, Among Employed Workers**

<table>
<thead>
<tr>
<th>Feature of Plan</th>
<th>Strongly Favorable</th>
<th>Somewhat Favorable</th>
<th>Neutral</th>
<th>Somewhat Opposed</th>
<th>Strongly Opposed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Your employer would enroll you in the plan and set up your contribution through payroll deduction, unless you choose not to participate.</td>
<td>34%</td>
<td>35%</td>
<td>2%</td>
<td>13%</td>
<td>15%</td>
</tr>
<tr>
<td>The percentage of your salary contributed to the plan would automatically increase when you get a raise, unless you choose for this not to happen.</td>
<td>32%</td>
<td>33%</td>
<td>1%</td>
<td>16%</td>
<td>17%</td>
</tr>
<tr>
<td>Your contributions would automatically be invested for you unless you choose investments on your own.</td>
<td>23%</td>
<td>36%</td>
<td>2%</td>
<td>19%</td>
<td>19%</td>
</tr>
</tbody>
</table>


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Both current participants and non-participants in DC plans are receptive to automatic enrollment, according to the “2006 Retirement Confidence Survey (RCS),” with 69 percent strongly or somewhat favorable toward the practice and 2 percent neutral. Support for auto-enrollment also spans generational boundaries, according to Prudential Retirement’s “Fifth Annual Workplace Report on Retirement Planning.” The survey found that workers between the ages of 21 and 30 favored automatic enrollment in DC plans by a margin of two-to-one, and 75 percent of Baby Boomers in the 55–66 age bracket said they would have been “grateful” or “optimistic” if they had been automatically enrolled in their employers’ plans. An even greater number of older workers—80 percent—“strongly” or “somewhat strongly” recommended automatic enrollment for their younger counterparts.

Prudential Retirement Recommendations:

1. Apply automatic enrollment to new hires and non-participating eligible employees.
2. Revisit enrollment with non-participating eligible employees on an annual basis.

Older Workers’ Recommendation to Younger Workers: Autopilot Features Versus Do-it-yourself Approach

<table>
<thead>
<tr>
<th>Feature</th>
<th>Strongly/somewhat recommend do-it-yourself approach</th>
<th>Don’t know</th>
<th>Strongly/somewhat recommend auto approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Automatic enrollment</td>
<td>15%</td>
<td>5%</td>
<td>80%</td>
</tr>
<tr>
<td>Minimum contribution</td>
<td>14%</td>
<td>6%</td>
<td>80%</td>
</tr>
<tr>
<td>Contribution escalation</td>
<td>19%</td>
<td>6%</td>
<td>75%</td>
</tr>
<tr>
<td>Asset allocation</td>
<td>24%</td>
<td>6%</td>
<td>70%</td>
</tr>
<tr>
<td>Retirement income</td>
<td>21%</td>
<td>7%</td>
<td>72%</td>
</tr>
<tr>
<td>Total package of auto pilot features</td>
<td>19%</td>
<td>5%</td>
<td>76%</td>
</tr>
</tbody>
</table>

Default Savings Rate

There is widespread agreement among economists and retirement specialists that automatic enrollment positively affects participation rates in DC plans. The Financial Economists Roundtable (FER), a group of 52 prominent economists which has been meeting once a year since 1993 to address key economic issues, singled it out in “Best Practices for the Design of Defined Contribution Pension Plans,” a paper it released in November, 2006. However, while endorsing the practice of auto-enrollment, the FER raised questions about the current default savings rates used in most DC plan designs.

The most common default savings rate among DC plans is 3 percent, according to PSCA research, while economists generally recommend a rate of at least 6 percent. In many cases, companies have adopted the 3 percent default rate for fear that setting a higher rate would reduce enrollment. However, there is solid evidence that a default rate of 6 percent has no negative impact on enrollment levels. In addition, a working paper prepared for the National Bureau of Economic Research found that once a plan’s default rate is switched to 6 percent, virtually no new hires select a 3 percent contribution rate.16 Once again, inertia is leveraged in a positive manner through the incorporation of behavioral elements into plan design.

The Financial Economists Roundtable (FER) recommends that new employees be automatically enrolled unless they take the initiative to opt out—it noted that contribution rates are often too low to provide adequate retirement income—and the FER was intrigued with the Save More Tomorrow Plan, where employees commit to increase their contribution rates at a later date.15

Prudential Retirement Recommendation:

4. Set the automatic enrollment default rate equal to the greater of:
   • a 6 percent contribution; or
   • the plan’s maximum match percentage.


Asset Allocation

Behavioral scientists identify “information overload” as a factor that can play a role in preventing workers from taking action on a retirement savings plan. Faced with an overabundance of choices, a significant number of people will make no choice at all. Even among those workers who are strongly motivated to participate, most will lack the expertise to decide which investment choices best meet their needs. That is why the FER and other financial experts recommend that DC plans automatically default to a diversified portfolio with an asset allocation mix reflecting the saver’s current situation and with the flexibility to adjust appropriately as the saver draws closer to retirement age and his or her needs change.

Offering asset allocation tools such as Prudential Retirement’s GoalMaker can help make DC plans more attractive to participants. GoalMaker allows plan participants to target the investment options best-suited to their retirement goals by using investment options offered through their plan to create 12 model portfolios. It offers self-evaluation tools to help participants determine their level of risk-tolerance and tailor investment portfolios that match their time horizon to retirement. GoalMaker also includes features such as automatic rebalancing and automatic age adjustment to keep participants’ portfolios on target.

Automatic Contribution Increase

Automatic increase of contribution rates in DC plans is one of the key best practices recommended by The Retirement Security Project as a solution to the tendency of participants to passively maintain the same contribution rate over time—again, inertia. Research has demonstrated the ability of automatic contribution increase programs to drive substantial increases in contribution rates over time for those participating in the programs relative to other 401(k) plan participants. The number of DC plans offering automatic contribution increase is on the rise, increasing from 8.5 percent of all plans in 2004 to 14.8 percent in 2005, according to the latest PSCA survey.

Prudential Retirement Recommendations:

6. Apply Contribution Accelerator to new and existing participants.
7. Add Contribution Accelerator to plans with automatic enrollment.
8. Offer Contribution Accelerator as an opt-out or default program.
9. Increase deferrals in Contribution Accelerator by 2 percent per year.
10. Use the plan’s maximum deferral as the cap for the Contribution Accelerator program.

Prudential Retirement Recommendation:

5. Automatically enrolled participants should be defaulted into age-appropriate investments that offer professional asset allocation. Prudential Retirement offers GoalMaker and Retirement Goal Funds (target maturity funds) for that purpose.

Encouraging Comprehensive Planning
Research and surveys deal with averages and means, but in the real world, DC plan sponsors have to deal with a variety of participant issues and needs. Job-changers may need help with rollovers, new hires may need education in the basics of saving and investing, and those nearing retirement may seek counsel for separation issues and structuring their plans to maximize income flow.

To be truly relevant, a DC plan must meet the needs of all its participants at all stages of their journey toward retirement, including:

• Access to ongoing guidance and education;
• Needs-based and value-based solutions, encompassing growth, protection or income;
• Answers to investing, tax and planning questions;
• Explanations of distribution options; and
• Development of investment strategies for out-of-plan assets and overall approaches for transition to retirement.

Consolidated resources to meet these needs should include a dedicated client service team staffed, in part, by objective, experienced retirement counselors who can offer a range of income solutions. These are essentials of optimal plan management.

Prudential Retirement Recommendation:
11. Deliver comprehensive counseling and assistance on rollover and transition; and offer one-on-one educational services to job-changers and retirees.

The Ultimate Goal: Lifetime Income
A great deal of emphasis is placed on the wealth accumulation phase of retirement planning; so much so that plan sponsors and participants often lose sight of the ultimate goal—guaranteed lifetime income. In some cases, participants are overly focused on a specific number that represents, in their minds, a goal they must achieve in order to retire. More common are cases where participants simply are not saving enough. In either case, the outcome is the same—failure to create a plan that provides the income they will need during retirement.

The problem has become even more acute as America’s 78 million Baby Boomers attempt to convert their account balances into income that will not only sustain their standard of living, but accommodate significant challenges:

• Increased life expectancies;
• Medical and long-term care expenses; and
• Inadequate savings.

Prudential’s 2006 “Workplace Report on Retirement Planning” survey found that 70 percent of older workers (between the ages of 55 and 64) would welcome an option that converts their DC plan assets into a guaranteed income stream. The widespread confusion over income options, and the tendency of participants to select a cash distribution, point to the importance of offering an in-plan solution.

Prudential Retirement Recommendation:
12. Offer an in-plan income solution, Prudential IncomeFlex, that does not require annuitization, but instead offers:
• Guaranteed lifetime income;
• Upside potential and downside protection;
• Money management control and flexibility; and
• Optional spousal benefit.
Perhaps the most telling affirmation of the well-documented shortcomings of DC plans—and the reluctance of plan sponsors and providers to respond with the kind of radical redesign those shortcomings demand—is the message inherent in the federal government’s recent enactment of the Pension Protection Act of 2006 (PPA). The substantial reforms to DC plans included in that legislation are a tacit acknowledgement on the part of the federal government of the pressing need to change participant behavior and attitudes toward retirement saving as a key to improving the DC plan’s positioning as a reliable provider of lifetime income.
Significantly, many of those changes reflect the best practices Prudential Retirement recommends to redesign DC plans for better outcomes:

**“Autopilot” Features**
The PPA makes it easier for companies to automatically enroll eligible employees in their DC plan by preempting state wage withholding laws that impede automatic enrollment in ERISA-covered plans. Studies show that participation rates increase significantly when employees are automatically enrolled in DC plans, unless they take specific action to opt out. To enjoy safe harbor protection, the legislation requires plans with automatic enrollment to set initial employee contribution rates at no less than 3 percent of pay and to increase the rate by one percentage point a year until reaching 6 percent, but never more than 10 percent.

This provision potentially has positive implications for workers at all levels of the income spectrum. It likely will increase participation rates among low-income employees, the group currently least likely to do any saving for retirement. It also may increase allowable contribution rates for highly compensated workers.

Other PPA provisions in the “autopilot” area include:

- Shielding employers from liability in the selection of default funds.
- Providing a safe harbor for avoiding discrimination and top-heavy testing for plans that automatically enroll participants.
- Allowing for the return of employee contributions to participants who opt out of the plan within 90 days.

**Guaranteed Lifetime Income**
A provision in the PPA makes it easier for sponsors to offer guaranteed lifetime income solutions in DC plans. It repeals the applicability of the Department of Labor’s “safest available annuity” standard for annuities purchased under defined contribution plans, and it requires that agency to issue new guidance in this area.

**Investment Advice**
A new prohibited transaction exemption allows plan service providers to offer investment advice to participants and provides protection for employers and plan sponsors from liability for advice given under this exemption. The rules permit plan administrators to provide advice using a computer model certified by an independent third party or under a level-fee agreement. Employers continue to have a fiduciary duty to prudently select and monitor the investment advice provider.
The problems and challenges facing workers who are relying on Defined Contribution plans as a critical source of income in retirement have been well documented. Now, it’s time to focus on solutions. Plan sponsors can play a critical role in that regard, and Prudential Retirement can help them do it. The good news is that younger workers appear enthusiastic about the changes suggested above and are eager to embrace a radical redesign of U.S. retirement plans. Even among older workers, where resistance to change is most deeply embedded, seven in 10 wish, from the vantage point of hindsight, that their plans had offered features such as automatic enrollment, default contribution rates, automatic contribution acceleration, automatic age- and risk-based investment rebalancing, and automatic enrollment in a plan that provides guaranteed, lifelong monthly income upon retirement.18
Prudential Retirement provides products and services that help people achieve the financial security they need to live fulfilling lives today and imagine new possibilities for tomorrow. Our approach focuses on leveraging the lessons of behavioral finance through the automation and simplification of the most critical components of Defined Contribution plans, including enrollment, asset allocation, and contribution escalation. It’s an approach that EBRI says Congress has “implicitly endorsed” with the enactment of the Pension Protection Act of 2006.

Prudential Retirement provides consolidated resources to meet all the needs of DC plan sponsors and participants. With more than 80 years of experience, we offer a dedicated group of professionals to provide retirement plan solutions for public, private, and non-profit organizations. Our services include state-of-the-art recordkeeping, administrative services, investment management, comprehensive employee investment education, and communications and trustee services.

We are your Rock for Retirement.

Plan Sponsor Impact Tool

Prudential Retirement offers a formal evaluation of how these recommended best practices can positively impact your organization’s Defined Contribution plan. To arrange an evaluation using our Plan Sponsor Impact Tool, please contact your Prudential Retirement representative or financial advisor. Or call to speak with a Prudential Retirement sales professional toll-free at 800-353-2847.
There is a growing realization among retirement plan sponsors, advisors, consultants and industry experts that the DC plan is not being used to maximum advantage. Without significant plan design changes, millions of Americans who receive retirement benefits through work will fall further and further behind in their efforts to achieve a secure retirement. Our failure to correct this problem will produce further demands on the already strained, three-legged stool of Social Security, personal savings and traditional pensions.

To help ensure that DC plans are employed appropriately and used to fullest advantage, Prudential Retirement proposes a series of prescriptions based on: the realities of behavioral finance; the time-tested elements of the DB model; and the benefits of risk management. Our goal is to help sponsors and participants realize the full promise of the DC plan.

Based on these principles, Prudential recommends the following best practices:

**Provide a path for automatic savings**
- Apply automatic enrollment to new hires and non-participating eligible employees.
- Revisit enrollment with non-participating eligible employees on an annual basis.
- Utilize Contribution Accelerator.

**Encourage savings with a default rate**
- Set the automatic enrollment default rate equal to the greater of:
  - a 6 percent contribution; or
  - the plan’s maximum match percentage.

**Provide an asset allocation tool**
- Automatically enrolled participants should be defaulted into age-appropriate investments that offer professional asset allocation. Prudential Retirement offers GoalMaker and Retirement Goal Funds (target maturity funds) for that purpose.

**Help ensure contributions increase appropriately**
- Apply Contribution Accelerator to new and existing participants.
- Add Contribution Accelerator to plans with automatic enrollment.
- Offer Contribution Accelerator as an opt-out or default program.
- Increase deferrals in Contribution Accelerator by 2 percent per year.
- Use the plan’s maximum deferral as the cap for the Contribution Accelerator program.

**Offer personalized guidance and solutions**
- Deliver comprehensive counseling and assistance on rollover and transition; and offer one-on-one educational services to job-changers and retirees.

**Help secure guaranteed lifetime income**
- Offer an in-plan income solution, Prudential IncomeFlex, that does not require annuitization, but instead offers:
  - Guaranteed lifetime income;
  - Upside potential and downside protection;
  - Money management control and flexibility; and
  - Optional spousal benefit.
Prudential IncomeFlex funds are separate accounts 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.

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