Prudential

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Prudential Investment Management Services, LLC
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March 7, 2016
Christina Elliott
SCIB Executive Director
Office of State Treasurer John Chiang
915 Capitol Mall, Room 110
Sacramento, CA 95814
And via email

Dear Christina,

Prudential very much appreciates the opportunity to provide written comments on the "Overture Financial Final Report to the California Secure Choice Retirement Savings Investment Board", prepared by Overture Financial LLC. Prudential is the second largest life insurer and a top 10 global asset manager with over $1.2 trillion in assets under management. We are the leader in delivering income and protection solutions in the defined contribution marketplace. We help meet the needs of over 4 million participants and annuitants, and we are the largest in-plan guaranteed lifetime income provider, with a 47% market share.

Prudential has long been committed to expanding retirement savings opportunities for all working Americans,[1] and has long been concerned about what is often referred to as the "retirement coverage gap," that is, the absence of workplace based retirement savings opportunities for employees in many of today's small businesses. It is well established that employer-sponsored retirement savings plans have become a critical component of the private retirement system in the U.S., and a proven tool for helping working Americans prepare for life after work. According to calculations by the nonprofit Employee Benefit Research Institute, workers earning between $30,000 and $50,000 per year are 16.4 times more likely to save for retirement if they have access to a workplace plan.

Unfortunately, tens of millions of working Americans don't have access to a plan on the job, leaving many ill-prepared to meet their financial needs after they stop working. With 10,000 individuals reaching retirement age each day, this is a large and growing problem. We know that a comprehensive retirement plan requires a three-legged stool – Social Security, personal savings, and pensions. While Social Security is a critical program, for median income earners, it replaces only 47% of pre-retirement income,

[1] See Prudential white paper entitled *Multiple Employer Plans: Expanding Retirement Savings Opportunities* (2015) at http://research.prudential.com/documents/rp/mep_paper_final_2015.pdf.

leaving those without a workplace retirement plan with a potentially significant income gap in retirement.

The workplace retirement system works very well for employees of medium and large companies. Employees of small companies, however, are far less likely to have access to savings opportunities. According to data from the Bureau of Labor Statistics, only 50% of workers in firms with fewer than 100 employees have access to retirement plans at work. This compares to 89% for workers at larger firms.

This retirement coverage gap is especially problematic given that small employers provide jobs for a large and diverse section of the American population. Small businesses in the private sector provide over 30 million jobs for women. Small businesses employ over 12 million Latino Americans, 6 million African Americans, and 4 million Asian Americans - and yet, only 50% of employees of small businesses have access to a workplace retirement plan.

The retirement coverage gap can and should be narrowed. We commend the SCIB for its significant accomplishments in developing the program to provide retirement plan access to California's 6.8 million private sector employees who don't have a retirement savings plan at work, and congratulate the Board on the important step of producing this report. We share a common goal- to expand workplace based retirement coverage, and to enable financial security for all of California's workers. Prudential also shares many of the core principles and statutory objectives that you have focused on including low cost and simplicity. We have appreciated the opportunities to discuss the Program with the Board to date. It is important that every feasible effort to expand retirement coverage be successful, and we respectfully submit the following comments on the report for the Board's consideration.

Default Contribution Rate of 5%, with Automatic Escalation to 10%

Prudential commends the Board for the recommendation of a default contribution rate of 5%, with Automatic escalation in 1% increments up to 10% (after program phase in, subject to recordkeeping coordination.) While there are no hard and fast rules as to what constitutes an optimal default deferral and escalation rate, Prudential Retirement's accumulated data suggests that a 5-6% default deferral rate, with 2% annual acceleration up to a cap of at least 10-12% significantly improves the likelihood of successful retirement outcomes while maintaining participation levels.[2] A default contribution rate of 5% will go a long way to delivering meaningfully higher Retirement Security.

Multiple Employer Plan

The report concludes that California policymakers should consider whether the Board should have the discretion to establish a Multiple Employer Plan (MEP) in the future to

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[2]. See Prudential white paper entitled *Overcoming Participant Inertia* at
http://research.prudential.com/documents/rp/Automated_Solutions_Paper-RSWP008.pdf

receive voluntary employer matches to employee contributions. A MEP is an arrangement that enables unrelated employers to join together to sponsor a single employee benefit plan. MEPs have been utilized successfully for years by trade associations and professional employee organizations. Prudential is working with Congress to broaden the availability of MEPs to unrelated employers ("Open MEPs").[3]

The Department of Labor, through its Interpretive Bulletin § 2509.2015-2[4], gave states the unique authority to create an Open MEP. This authority for California to create an Open MEP was not available until late in the feasibility study process (November 2015). We strongly encourage the board to consider offering a MEP as a complementary option to the IRA, and to use it for a broader range of circumstances than receiving voluntary employer matches to employee contributions.

MEPs offer a number of benefits when compared to an IRA program, for both employees, employers, and the state. From an employee's perspective, one of the most important differences between a MEP offering a 401(k) plan and the proposed program is the amount of total contributions to the retirement plan that are permitted. The total contribution limit (in 2016) for individuals under 50 years old is $18,000 in a MEP sponsored 401(k) plan, compared to $5,500 for an IRA. $5,500 may be an inadequate limit for many individuals given their income needs in retirement. Next, as recognized in the report, a MEP can receive voluntary employer matches to employee contributions. Employer contributions can be an important component of retirement savings.

A broader range of investment options may be available in a MEP than available through the program, based upon the recommendations in the final report. Principal protection options, which guarantee principal and accumulated interest, were not part of the final report's recommendations. Given the median wage & salary income for this group is $23,000, and the mean is $35,000, and the number of individuals with limited investment experience, principal protection options may be an important investment option to offer this population. Furthermore, given the goal of delivering retirement security, it is important to think about retirement security in terms of income in retirement, in terms of creating a retirement income paycheck. To achieve this goal, guaranteed lifetime income investment options such as a variable annuity with a Guaranteed Minimum Withdrawal Benefits (GMWB) can create lifetime retirement income, and may also be available in a MEP.

From an employer's perspective, as part of implementing the Program, California's small business community will need to undergo a series of startup related costs. These costs may include updating payroll systems, providing notices as required by the program, and maintain and providing records to the state. A MEP would provide the advantage of allowing small businesses in California the ability to offset some of these costs, through tax credits. Under current tax law, small businesses can claim a tax credit for starting a retirement plan. The credit equals 50% of the costs, up to a

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[3] http://www.finance.senate.gov/imo/media/doc/Kalamarides%20Testimony%20Jan%2026%202016%20-%20Senate%20Finance%20Comm.pdf

[4] 80 Fed. Reg. 71936 (November 18, 2015).

maximum of $500 per year for each of the first three years of the plan. This tax credit is not available for small businesses under an IRA Program.

From the state and employer's perspective, a MEP, as an ERISA plan, benefits from a long-standing regulatory structure with important consumer protections, and strong protections from creditors. The State Sponsored IRA regulatory framework is new, and there are some unknowns for employers. For example, the ERISA implications if a handful of employers do not comply with the compliance requirements of the program are at this time unclear. Given these differences, some employers and employees would be more comfortable with the clarity and protections inherent in the ERISA framework.

Guaranteed Lifetime Income as part of the Default Investment Option

With an estimated 10,000 Americans reaching retirement age every day, we know that very few of those individuals are being offered the opportunity to consider a guaranteed lifetime income option as part of their retirement plan. We also know that few of today's workers are able to manage investment and longevity risks in retirement on their own. As recognized by the Council of Economic Advisers' February 2, 2012 Report, *Supporting Retirement for American Families*, this is a particularly significant issue for women, who tend to have lower retirement savings rates than men, while also having longer life expectancies. Guaranteed lifetime income solutions provide a means by which all workers can enjoy both certainty and security during their retirement years.

The report concludes that initially (in the first 3-5 years), account balances for retirees under the California Secure Choice Plan will be too small to convert to a meaningful income stream, and therefore the Board has time to consider options before selecting a default payout method. It also considers Variable Annuities with GMWB, and states that the eligible participant universe in the first 3 to 5 years after the launch of California Secure Choice is unlikely to have sufficient balances at retirement to afford meaningful income replacement from annuitization, and recommends considering offering this option 3-5 years after launch.

The report does not make the connection between the powerful behavioral impact of automatic enrollment, a default investment option, and automatic escalation during accumulation, and the powerful behavioral impact of selecting a default payout method including guaranteed lifetime income at the inception of the program. In an effort to maximize participation and contributions, the Board should consider offering a default investment that includes guaranteed lifetime income, such as Variable Annuities with GMWB, at the inception of the program, and consider selecting a default payout method at the inception of the program.

To deepen our understanding of participant behavior, Prudential has in the past completed several proprietary research studies, including analyzing our in-force book of business. Our research showed that participants were more likely to "stay the course" when guaranteed lifetime income is part of their retirement plan. We found that plan participants with guaranteed lifetime income were:

- more inclined to stay invested during market turmoil
- better diversified, and
- contributed more than participants without guaranteed income.[5]

Furthermore, to unlock the full potential of lifetime income, plan design plays a pivotal role. We looked at our inforce book of business to see how different combinations of plan design features interact to produce the best participant outcomes, where participation rates were the highest. We found that participation was the highest when automatic enrollment was combined with a default investment that included guaranteed lifetime income. [6]

We once again thank the Board for the opportunity to provide comments on the final report. Please feel free to contact me with any questions concerning these comments.

Sincerely,

Bennett Kleinberg

Bennett Kleinberg
Vice President, Institutional Investment Solutions
Prudential Financial

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[5] See Prudential white paper entitled *Better Participant Outcomes Through In-Plan Guaranteed Retirement Income* at http://research.prudential.com/documents/rp/BetterParticipantOutcomesThroughIn-PlanGuaranteedRetirementIncome.pdf

[6] See Prudential white paper *entitled Guaranteed Lifetime Income and the Importance of Plan Design* at http://research.prudential.com/documents/rp/Guaranteed-Lifetime-Income-and-the-Importance-of-Plan-Design.pdf