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Stable Value Funds and Retirement Security
in the Current Economic Conditions
2009 ERISA Advisory Council
July 22, 2009

Thank you for the opportunity to testify. My name is James King and I am a Vice President and head of Prudential Retirement's Stable Value Markets Group. I am responsible for Prudential's full service and investment only stable value products.

Prudential Retirement is a major provider of retirement services with 3.6 million participant accounts and total retirement account values of \$150.2 billion. We have over 30 years of experience in the stable value industry with \$50 billion in stable value and funding agreement assets under management. Our full service stable value assets total \$35 billion and our total general and separate account stable value assets are \$29 billion.¹ My testimony will focus on general account and separate account stable value products, although Prudential offers a range of other stable value products and also has experience as a wrap provider.

The events of the last twelve months have underscored the importance of offering safe investment options in retirement savings vehicles such as DC plans. Millions of Americans have lost a significant portion of their retirement assets, and many of these individuals have had to delay retirement.

The collapse of the financial markets highlights the need for investment options that both protect and grow principal. Participants must have an investment option that enables them to have retirement security. This includes early investors in DC plans as well as those nearing retirement. Stable value products, with their relatively high returns, low volatility, and protection features such as capital reserves to back guarantees, provide a compelling solution and as such it is essential that stable value products be classified as a qualified default investment option.

Stable value products are a key asset in DC plans with over \$642 billion invested in stable value assets. Approximately half of all 167,280 DC plans offer stable value options.² DC plan sponsors should provide their participants with the safest investment option possible. A critical element of plan design is for plan sponsors to offer an investment option that protects participants' principal investment and provides a predictable stream of returns that exceed the rate of inflation.

Stable value products are a solution that offers participants safety of principal and the ability to withdraw funds at book value while providing higher levels of return than an intermediate bond fund and volatility similar to that of money market funds. From January 1989 to December 2008, stable value funds net annual returns were 6.3% versus 4.1% for money market funds, and 5.7% for intermediate government / credit funds.³ The 2008 annual return for the S&P 500 was -37% while stable value funds returned 4.68%.⁴

Stable value funds are able to deliver high returns with low volatility because of the unique insurance protections built into these products. Stable value products combine an investment,

¹ As of 12/31/2008

² 13th Annual SVIA Stable Value Investment & Policy Survey

³ David Babbel and Miguel A. Herce, Wharton School

⁴ 13th Annual SVIA Stable Value Investment & Policy Survey

usually in intermediate-term fixed income securities, with an insurance contract that guarantees the return of the investor's principal and accumulated interest earnings. Principal balances grow at the crediting rate promised by the stable value product provider. The crediting rate is usually only reset periodically, such as every quarter, and may be guaranteed to be above a "floor" for the duration of the investment.

Stable value products minimize risk by investing in high quality securities. The insurance contract provides an additional layer of protection for participants by promising the return of their principal and accumulated interest earnings whenever they wish to redeem their investment, even if the actual market value of assets may have declines by this time. As a result, all stable value products protect participants against market risk.

The stable value market has been evolving since the 1970s. General and separate account stable value products are a large component of this market.

- General account stable value funds: Plan sponsors invest their assets directly with the insurer providing this product. The insurer is both the investment manager and the guarantee provider. The insurer guarantees the plan's principal against any loss, including the default of any underlying securities, and also promises that the crediting rate will never fall below a minimum. The assets are invested by the insurance company within its general account, which is used to support all of the liabilities that the insurance company is underwriting across multiple lines of business.

Plan sponsors and investment consultants need information to evaluate the benefits and risks of stable value products, especially given these funds unique combination of an insurance guarantee and a fixed income portfolio. During the fourth quarter of 2008, Prudential adopted practices that significantly increased the transparency of our general account stable value products' investment strategy and portfolio holdings. These new disclosures, which have been very well received by our clients and their advisors, are in addition to the comprehensive statutory filings we have historically provided to state insurance regulators. These statutory filings are available to the public and include a line by line listing of each individual holding in all of the insurance company's general and separate accounts. Lastly, we also provide disclosure on performance and product characteristics to both participants and plan sponsors.

- Separate account stable value funds: These products differ from general account products in that the insurer invests the plan's assets in a separate account rather than the insurer's general account. As a result, the assets in the separate account can only be used to satisfy claims related to the investments made in the separate account, and are insulated from any claims on the insurer's general account.

General and separate account products provide an unconditional guarantee, backed by an insurance company, of the return of principal and accumulated earnings to the investor. As a result, such products protect participants from both market value risk, caused by short-term

fluctuations in the prices of the underlying securities, and credit risk, caused by the possibility of default in an underlying security.

In order to provide these guarantees, all stable value products have certain rules on the timing and level of plan withdrawals to prevent rapid, large-scale outflows that would strain the ability of the product provider to meet its obligations. However, participants in a DC plan can remove their funds at book value for transfers to other investment options under the plan and for benefit responsive purposes such as death, disability, retirement, and hardship. For plan sponsors wishing to exit the product, payment is normally available immediately at market value or book value over time.

Not surprisingly, there is concern about whether stable value providers can meet their obligations during the current economic crisis. However during 2008, every stable value fund produced a positive return for the year.⁵ There are several reasons why stable value providers are able to meet their commitments.

First, stable value providers are regulated by a number of government entities, such as the Securities and Exchange Commission and state insurance regulators, which are focused on ensuring stable value products are designed appropriately. For insurance company general and separate account stable value products, the scope of state regulation is broad, extending to areas such as required levels of capital and surplus, the calculation of policy reserves, investments, sales practices, market conduct, and company operations. The reserving of capital distinguishes stable value providers from traditional investment products, which do not reserve capital to protect investors from losses.

Second, insurance companies must file annual and quarterly reports that state insurance departments use to evaluate whether there is any cause for concern about the company's finances. Insurance companies are also subject to rigorous audits by the state authorities to gain firsthand knowledge on their financial condition. These audits are performed "on-site," and independent accounting firms are retained to assist the state examiners.

Third, the guarantees inherent in stable value products align the interests of investors and asset managers because stable value providers have an incentive to invest conservatively with high quality, diversified portfolios.

If, despite these comprehensive protections, an insurer's financial condition is judged critical, insurance law provides for the supervision and, if necessary, liquidation of the insurance company by the insurance commissioner. In the case of Prudential Retirement Insurance and Annuity Company regulated by the State of Connecticut, policy claims (insurance company stable value

⁵ In the case of the Lehman Brothers bankruptcy, despite a negative return of 1.7% for the month of December 2008, Lehman's Stable Value Fund earned 2% for the year. Source: "Answers to Issues Raised in the January 9, 2009 Wall Street Journal Article," Stable Value Investment Association, January 9, 2009.

fund participants are generally considered policyholders) represent the first significant category of claims, ahead of general creditor and stockholder claims.

In the event that an insolvent insurer's assets do not fully satisfy policyholder claims, all states provide Guaranty Association protection. Under the Guaranty Association statutes, all insurers doing business in a state where covered parties reside are assessed a premium to provide coverage when another insurer becomes insolvent. Through this mechanism, policyholders may be protected from loss due to the insurer's insolvency, subject to restrictions and limits, which vary considerably from state to state.

Plan sponsors need to provide safer investment options that meet the needs of plan participants. Stable value products provide safety of principal through their protection features with returns similar to that of intermediate bonds but with significantly less volatility. This makes stable value products a compelling solution for plan sponsors and participants and a very attractive choice for inclusion as a qualified default investment option.

Thank you.