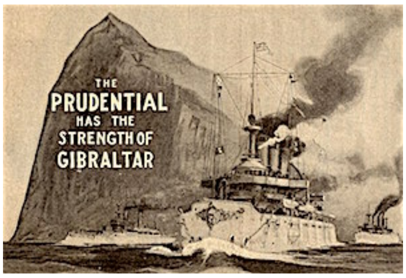
A Chip Off the Old Rock?

By Kerry Pechter *Thu, Apr 15, 2021*

Bloomberg reported this week that Prudential is considering selling its retirement plan recordkeeping business. Prudential didn't confirm the report, but several industry insiders did. Low interest rates, high costs of IT makeovers, and sticky stable value fund guarantees are driving the move, RIJ was told.



With ever-rising technology costs and a squeeze on their margins, US retirement plan recordkeepers have had only one refuge of profitability: Becoming big enough to achieve the necessary economies of scale. The industry has dramatically consolidated, and Prudential may be on the verge of exiting the game.

A report on Tuesday by Bloomberg said that Prudential, the eighth largest recordkeeper by assets under management in the US, is thinking about selling its 401(k)/403(b)/457 retirement plan recordkeeping business. Sources weren't identified and Prudential didn't confirm the report.

"The Newark, NJ-based life insurer is working with a financial adviser to find buyers for its so-called full-service solutions business," said Bloomberg, attributing the information to unidentified sources. "No final decision has been made and Prudential could opt to keep the business."

One possible reason for a change: the need for a big information technology upgrade. One plan adviser who has worked with Prudential for years, Barbara Delaney of HUB International, said that Prudential has multiple legacy systems, while competitors Empower and Vanguard have gone to faster, more agile cloud-based computing.

"This is no surprise. 401(k) margins are so small. Transactional businesses are tough to run. Prudential probably said, 'Let's focus on what we're good at: life insurance and annuities," Delaney told RIJ today. "And even Prudential employees seemed frustrated with their own systems."

To illustrate the need for up-to-date technology, Delaney pointed to the passage of the CARES Act in 2020, which suddenly allowed retirement plan participants to take more money out of their accounts. Recordkeepers had to adapt within the space of hours, and all recordkeeping systems were overtaxed.

Prudential may also be underwater on the stable value funds offered in its retirement plans. As interest rates have gone down, stable value fund providers in some cases aren't earning enough on their general account investments to cover the minimum yields contractually promised to plan sponsors.

The plan recordkeeping business in the US has been consolidating for years. In the past year alone, MassMutual and Wells Fargo sold their retirement plan businesses to Great-West Lifeco, the second largest recordkeeper by AUM, and Principal, the fifth largest, respectively.

"This was not unpredictable. Prudential recently pulled out of the retail GLWB business, and the trend is toward of recordkeeper consolidation," said Michelle Richter of Fiduciary Advisory Services. Another life/annuity industry insider told *RIJ* yesterday, "My understanding is that [a Prudential deal] would be similar to the MassMutual sale. Retirement business very much a scale play."

Scale is measured in fees on assets under management, or AUM. Fidelity leads in recordkeeping AUM with more than $2 trillion. Empower is a distant second, with almost $500 billion, followed by Vanguard, Alight, Voya, Principal and T. Rowe Price. (Alight is the new name for Aon Hewitt's benefits business, now owned by the asset manager Blackstone. Empower is a unit of Great-West Lifeco.) Prudential was eighth in 2020 with about $180 billion (all AUM data come from *Plan Sponsor* magazine).

Stable value funds, with their modest but reliable yields, used to be the primary default investment for 401(k) plan participants who didn't choose their own investments. The Pension Protection Act of 2006 allowed target-date funds and managed accounts to be default alternatives. These defaults included equities, and so offered much more higher upside than stable value funds. The Great Financial Crisis also ushered in the Fed's ultra-accommodative interest policy, whose low rates reduced the returns on stable value funds.

While the rates on many stable value funds were re-set every year, some retirement plans included stable value funds with long-term minimum guaranteed rates as high as 3% or more. Those promised rates, which helped providers win business, are now the source of losses, in some cases. Delaney said she does not believe that underwater stable value guarantees would cause Prudential to leave recordkeeping, however.

Prudential's 10-K **filing** with the SEC on February 19, 2021, page 63, shows that $28.1 billion of the company's $62 billion in contracts promising guaranteed minimum returns have a floor return of between 3% and 4%. An addition $900 million worth have contracts with guarantees of greater than 4%. In total, 47% of those contracts have minimum guarantees greater than 3% at a time when the ten-year Treasury is earning 1.56%. “The funds need to earn 3% to cover contractual minimums and the insurer’s cost of capital,” a person familiar with stable value funds told *RIJ*.

Prudential had considered growing its recordkeeping business through acquisition, but now has apparently decided to go the other way. A person familiar with Prudential Retirement estimated that the recordkeeping business accounts for about 10% of Prudential Financial’s earnings and 7% to 8% of its employees.

Prudential has been an innovator in the in-plan annuity market. It began offering IncomeFlex, a guaranteed lifetime withdrawal benefit that could be wrapped around a plan participant’s Prudential target-date fund for an additional fee. That product—introduced a decade before the SECURE Act reduced barriers to annuities in plans—never reached critical mass, despite a big push from Prudential.

In the retail retirement space, Prudential had $171.4 billion in variable annuity assets under management at the end of 2020, according to Morningstar. That was more than any other firm expect Jackson National ($229.1 billion) and TIAA ($527.4 billion). TIAA’s VAs are primarily group annuities in 403(b) plans.