

## Getting the Best Program Design for California Secure Choice Requires Flexibility

*Comments by Hon. Joshua Gotbaum\**

Having worked for several years on secure choice proposals in several states and being a member of the legislative commission to design a program for the state of Maryland, it was a pleasure reading the market study of the Board’s consultants. Your work will help many other states as they consider these important, but very complex, issues.

*However, it would be a mistake to convert this excellent market and feasibility study into a final program design without further work – and a greater mistake to do so by freezing that program design into law.* I hope that, rather than doing so, California will enact legislation establishing requirements both for employers to offer retirement savings and also requirements for the California program, but leave the details of the program within those requirements to the judgment of the Board. An outline of such legislation is provided at the end of these comments.

### Should Investment Options for 6,000,000+ Californians be Frozen into Law?

The consultants have reviewed some, though certainly not all, investment options. They recommended two for immediate implementation, a target date fund or a pooled individual retirement account (IRA). They also recommended one for future implementation (a variable annuity with guaranteed withdrawal income), and one for consideration for future implementation (a multiple employer version of a 401k, sometimes referred to as a “MEP”).

The consultants recommended two approaches for immediate implementation. Both are feasible, but there are many more.

- *Target date funds* are already well-established and the regulations governing them are understood. Their shortcomings are also well-understood: they offer virtually no protection against market crashes. A person retiring with a target date fund in 2009 would have found their “nest egg” already broken and their retirement future uncertain.

#### Allowing flexibility in program design will achieve better retirement security

	Payroll Deduction IRA	SIMPLE IRA	401k Multiple Employer
<b>Employer Contribution</b>			
<b>Guarantee against Losing Savings</b>			
<b>Lifetime Income Options</b>			

Author's views. Characteristics simplified

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- The *pooled IRA* is the better alternative of the two. It is a thoughtful and creative way, authorized by SB1234<sup>1</sup>, to provide a cushion against market crashes without putting California on the hook. As the consultant report makes clear, the creation of a reserve in good years will ultimately enable the offsetting of losses during market downturns.<sup>2</sup>

Comments have been solicited as to which option the Board should recommend and the State of California should legislate. If the legislation authorizing a Secure Choice program is limited to only one approach of the dozens that are possible, ***the pooled IRA would be the better of the two – but there’s absolutely no reason to preclude alternative designs that likely would better fulfill the Board’s mandate by freezing the program design into the enabling legislation.***

I recommend that the State keeps its options open and not make the mistake of other jurisdictions (including the federal government) of putting all the eggs in one basket and hoping it’s the right one.

### Although the pooled IRA is preferable, neither of the two recommended approaches actually fulfills the Board’s mandate under SB1234

SB1234 set standards for California’s Secure Choice program that included some of the best features of traditional pensions (while making it clear that California would not accept the liabilities of such pensions). Among these were:

- ***Protecting Retirees’ Savings Against Market Crashes*** Section 100013 of SB1234 requires the board to “ensure that an insurance, annuity, or other funding mechanism is in place at all times that protects the value of individuals’ accounts.” The pooled IRA approach was recommended to achieve part of this requirement, but only part.
- ***Permitting voluntary employer contributions.***<sup>3</sup> While many small businesses cannot afford to add the costs of a retirement contribution, some can and would do so if it were part of the Secure Choice program and didn’t involve extra regulations, filings, and administrative hassle. Unfortunately, the payroll deduction IRAs that the consultants focused on don’t permit such contributions -- but there are other program designs that would.
- ***Guaranteed income for life.*** Since people are living longer but have no way of knowing how long they will live, most people with retirement savings accounts have no lifetime income except Social Security. They and their spouses are at great risk of simply running out of retirement savings – at an age when going back to work just isn’t possible.

The consultants recognized that their own recommendations failed to meet all the provisions of SB1234. They noted that other approaches could achieve them, but declined to recommend those approaches for anything other than possible future implementation. They noted that *voluntary employer contributions could be achieved with a 401k* (a multiple employer 401k plan, or “MEP”). 401k plans also

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<sup>1</sup> Section 100006 of SB1234 authorizes, but does not require, the Board to establish a “Gain and Loss Reserve Account” that would be used when market returns fall below projections.

<sup>2</sup> The head of retirement programs for Legg Mason, Gary Kleinschmidt, [supports the pooled IRA](#) as the better of those two approaches because it offers an “...opportunity to protect workers who may retire during a stock market decline.”

<sup>3</sup> Section 100012(k)

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offer other benefits, such as wider array of options and tax credits to offset the cost of implementation. They also noted that *achieving guaranteed lifetime income is possible using a variable annuity w guaranteed minimum withdrawal benefit* and recommended that, but only for possible future implementation.

There are other possibilities beyond those mentioned by the consultants. For example, employer contributions could be possible if a [SIMPLE IRA](#) were part of the Secure Choice offering.

### Options are available today that weren't when SB1234 was enacted.

The original Secure Choice proposal envisioned the state sponsoring a pooled investment, variable (but defined) benefit open to all employers in California. However, when California enacted SB 1234 in 2012, the legislation was limited to creation of a program of individual retirement accounts (IRAs), largely because any other kind of program would come under the federal Employee Retirement Income Security Act (ERISA): Small businesses were entirely unwilling to become fiduciaries by sponsoring an ERISA plan and the US Department of Labor said at the time that any ERISA-based program would be pre-empted and void by federal law.

The consultant market/feasibility study understandably limited itself to IRAs. It concludes that there will be adequate market demand to support a Secure Choice program and that several IRA designs could be practically and legally feasible. These findings are required by SB1234, but the consultant report went beyond that mandate to recommend a specific program design and only two possible forms of IRA.

Since 2012, however, the US Department of Labor (DOL) reversed its previous guidance:

- DOL has now modified ERISA requirements to allow California & other states to establish Secure Choice 401k's.<sup>4</sup> Corporate 401k's are widely regarded as offering superior options and lower fees than IRAs. They also permit voluntary employer contributions.
- The US DOL also has proposed a regulation that would provide a safe harbor for state-created IRA programs and has solicited comments on ways to improve its efforts.

As a result, California (and other states) now has a broader range of options than it did in 2012. Some of those options could better meet the objectives of SB1234.

Groups opposing a Secure Choice program point out that the regulatory environment is changing. They are right, but that's not an argument against authorizing a program – it's an argument against getting too specific about the specifics of a program, lest regulatory developments change the playing field. The Board, in its submission to the US Department of Labor, requested a series of changes to enable greater coverage and provide greater confidence in Secure Choice's legality. Others have made

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<sup>4</sup> These would be a type of multiple employer plans, or "MEP", which are authorized under ERISA.

While California could not require participation in an ERISA plan, it could require establishment by employers of an opportunity to participate in some kind of retirement savings plan. One means of satisfying that requirement could be participation in a state-sponsored 401k. Under the 9th Circuit decision in *Golden Gate Restaurant Assn. vs. City & County of San Francisco*, the requirement would not be pre-empted so long as there were other means of complying, such as establishment of a private IRA program (of which many are available).

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similar suggestions to broaden the applicability of the MEP 401k. It would be a shame for California to enact legislation this spring only to find that other IRA or 401k options are available and could be implemented within the program deadlines.

### **One Way Programs Fail is When Enabling Legislation is Too Specific**

My reasons for suggesting flexibility come in part from personal experience: I've designed and launched large governmental programs. For example, in the 1990's, under the leadership of then-Secretary of Defense William Perry, I proposed & negotiated legislation allowing the Department of Defense to use private capital to refurbish military family housing and then established an office within DOD to implement the program. There had been multiple attempts to do this since the 1950's: each failed because the legislation was too restricted, and the initial efforts couldn't be modified to work effectively. Learning from this mistake, we recommended to the US Congress that they authorize a range of authorities. Congress did so and the flexibility paid off: virtually all military family housing in America, some 200,000 homes, have since been built or refurbished.

Unfortunately, flexibility has not been the hallmark of retirement legislation. The history of retirement legislation is riddled with examples where well-intentioned legislated limitations turned potentially good ideas into also-rans. In the 1990's, for example, companies that wanted to preserve some of the benefits of defined benefit pensions began considering hybrid designs such as cash balance plans. However, legislation "enabling" such plans ended up imposing so many requirements that many companies instead chose to abandon DB pensions entirely and switch to 401k's.<sup>5</sup>

### **To Get the Most Out of California Secure Choice, Set Requirements & Let the Board Determine How Best to Meet Them.**

To date, the California Secure Choice Retirement Savings Investment Board and its consultants have done an admirable job with limited resources. Once it is clear that there will be a program and that it will involve millions of people and tens of billions of dollars, both service providers and investment firms will compete to expand your options beyond those that your consultants were able to consider. They will also "sharpen their pencils" and enable the Board to consider its options with both more and reliable information about costs and fees.

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<sup>5</sup> Another sad example was federal legislation intended to protect workers' rights to lump sum payments. It ended up encouraging companies to use lump sums to get out of their pensions. Both the US Treasury and DOL were disturbed by these developments, but didn't feel they could make changes without legislation. This fiasco is described a Brookings [summary of 2015 actions affecting retirement](#).

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For all these reasons, I hope the Board will consider recommending to the State legislation that sets the requirements for the Secure Choice program, but allows the Board to exercise its judgment on the details. Such legislation might provide:

- A requirement for businesses that don't otherwise a retirement savings opportunity to do so. This requirement would not apply to any business that lacked an automated payroll processing system.<sup>6</sup> Businesses could satisfy the requirement via the many privately-available IRAs or participation in the California Secure Choice program.
- Establishment by the Board of a default program option and such additional options as it considers appropriate to improve the retirement security of Californians<sup>7</sup>, subject to the following requirements:
  - No liability, contingent or otherwise, to the taxpayers and State of California;
  - Compliance with all applicable federal laws -- both tax and ERISA -- and state laws;
  - Implementation of a working program by a fixed date (e.g., two years after enactment)

With such legislation, California would build on the record it has established for thoughtful action, and may very possibly establish a model that can be adopted nationwide.

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<sup>6</sup> The reason for exempting businesses on the basis of not having an electronic and automated payroll processing system, rather than on the basis of the number of employees, is to expand retirement coverage while minimizing the burden on small businesses.

<sup>7</sup> These comments focus only on the issue of whether the State of California should decide *now* and freeze into legislation what investment approaches should be available under California's Secure Choice program. However, many of the same issues are presented in determining the default contribution rate and other aspects of program design. Those issues, too, are probably better left to the Board for determination, so that the Board will not have to wait for legislation to improve program designs.