Date: March 23, 2016

To: California Secure Choice Retirement Savings Investment Board

From: Nari Rhee, UC Berkeley Center for Labor Research & Education
Mohammad Baki, Overture Financial

Re: Response to Selected Public Comments Regarding the Financial Feasibility and Market Analysis Studies Conducted for California Secure Choice.

Several concerns regarding our Financial Feasibility Study and the Market Analysis were raised during public hearings and in comment letters to the Board. This letter provides several points of clarification regarding our methodology—including key assumptions—as well as factual correction regarding some misinterpretations of our Market Analysis findings. There were many other comments which we do not have time to respond to in writing, but would be happy to address if the Board wishes.

Our responses to key concerns gleaned from public comments follow. Highlights from our responses include the following:

- A 5% default contribution rate can be safely assumed to yield a 5% effective contribution rate, based on robust empirical data and data from our Online Survey.
- Our model is highly conservative in its key assumptions. The baseline model already assumes a 40-43% effective opt-out rate, when all factors are taken into account—below that of most voluntary/opt-in retirement plans. It also under-estimates participant incomes compared to current levels.
- A large majority of Program costs will consist of per-employee and per-employer unit costs to service accounts and process payroll deduction contributions. Thus even if a significant share of employers (especially large employers) were to peel away, the Program would still be self-sustaining.
- Contrary to some observations based on a misreading of selected statistics from our Online Survey of eligible workers, the actual survey findings support the need for an automatic retirement savings plan and indicate that a large majority of eligible workers want to take advantage of California Secure Choice. These findings are validated by a large body of existing empirical research.

1. The baseline feasibility model assumes a 5% default contribution rate. Shouldn't there be accounting for a significant share of employees choosing a lower contribution rate?

The joint letter for Association of California Life and Health Insurance Companies (ACLHIC) and American Council of Life Insurers (ACLI)[1] raise the concern that our financial feasibility model did not account for a significant share of participants electing lower contribution rates than the default, thereby generating significantly lower contributions than are projected by the model.

Our assumption that a 5% default contribution rate leads to an average contribution rate of 5% of covered payroll is conservative, in light of empirical data and our internal survey findings related to participant behavior in auto-enrollment plans.

Furthermore, the Feasibility Study includes analysis of an alternate scenario with a 3% default contribution rate, which still supports Program self-sufficiency, albeit with a longer time-frame and a larger startup loan.

Our Online Survey of 1,000 California workers eligible for the Program, conducted as part of the Market Analysis study, included a behavioral experiment to gauge potential opt-out rates and contribution rate elections in response to two different default contribution rate scenarios: 3% and 5%. We found no statistically significant difference in opt-out rates between the 3% and 5% scenarios. We also found that high-income workers are less likely than low-income workers to opt out (21% for $60,000+ vs 29% for less than $30,000 personal income).[2]

In terms of likely contribution rates among participating workers, both our Online Survey findings and existing empirical data on auto-enrollment support the conclusion that a 5% default contribution rate leads to an average deferral rate that is higher than 5%:

- In our Online Survey scenario with the 5% default contribution rate, one out of five respondents said they would stay in the program but choose a different contribution rate. Of this group, more than half (55%) chose a higher contribution rate than the default. High-income workers were particularly likely to choose a higher contribution rate.

[1] ACLHIC & ACLI, Letter to The Honorable John Chiang, California State Treasurer, March 10, 2016.
[2] Likewise, the Vanguard Group found that participation rates in auto-enrollment 401(k)s increased by income, from 87% among workers making less than $30,000 a year, to 94% among those making more than $75,000. At the same time, auto-enrollment caused the most dramatic increase in participation among workers making less than $30,000 a year, only 22% of whom participated in opt-in plans. Robinson, op cit.; Jeffrey W. Clark, Stephen P. Utkus, Jean A. Young, "Automatic Enrollment: The Power of the Default," Vanguard Research, January 2015. https://pressroom.vanguard.com/content/nonindexed/Automatic_enrollment_power_of_default_1.15.2015.pdf.

- T. Rowe Price found that in their auto-enrollment 401(k) plans with a default 5% contribution rate, 52.6% contribute at the default rate, 35.7% contribute more than the default, and only 11.8% contribute less than the default.[3]

- The Vanguard Group, the largest manager of 401(k) assets in the US, found that average contribution rates among participants increased over time in auto-enrollment plans with no auto-escalation—though to a lesser extent than in plans with auto-escalation.[4]

- Behavioral finance studies on 401(k) auto-enrollment have also found that with modest default contribution rates, participants are more likely to choose a higher contribution rate than a lower one, and contribution rates increase over time, even with no employer match.[5]

In summary, higher-income workers are more likely to participate than lower income workers; and participating workers are more likely to choose a higher deferral rate than a lower deferral rate compared to the default. In light of these facts, our financial feasibility modeling was conservative in its assumption that average deferral rates (as a percentage of participants' pay) would stay at 5% and not increase over time.

2. What if the Program does not realize key assumptions of the financial feasibility study?

As we explain below, our model and assumptions have additional measures built in that make them significantly more conservative than the explicit assumptions indicate. In addition, the cost structure of the Program will be such that its financial feasibility is much less sensitive to employer and employee participation rates than some believe.

A. 25% opt out rate in the baseline model.

In reality, the effective opt out rate in our baseline model is 40-43% compared to the current eligible population. This translates into participation estimates that are below those for a voluntary/opt-in plan.

The participant-driven opt-out rate (percentage of employees who actively choose not to participate) is just one component of the employee participation estimates in our model, which incorporate other conservative measures.

---

[3] Mark Robinson, "Success of Auto Enrollment and Auto Increase: Using Behavioral Finance to Improve Retirement Planning," Presented at EBRI Policy Forum, May 13, 2010. https://www.ebri.org/pdf/programs/policyforums/Robinson0510PF.pdf.

[4] Clark, Utkus & Young, op cit.

[5] See James Choi, David Laibson, Brigitte C. Madrian, and Andrew Metrick, "Saving for Retirement on the Path of Least Resistance," National Bureau of Economic Research, July 2004.

- We assume an additional 10% reduction in anticipation of Social Security number match problems.
- We also assume a significantly smaller eligible population than is likely: 6.3 million based on employment levels during the last recession. The current number of private employees age 18-64 without access to an employer-sponsored retirement plan is 6.8 million based on a 3-year average from 2012-2014, and 7.2 million based on 2014, according to data from the Bureau of Labor Statistics.
- This means that in the baseline scenario which assumes a 25% employee opt-out rate, the effective opt-out rate is actually between 40 and 43%--much higher than any behavioral finance studies suggest for an auto-enrollment program, and resulting in participation rates that are below that of opt-in plans.

B. *Average (mean) income of $45,000 for full time employee, which is higher than the median of $23,000 for the eligible population in the Market Analysis.*

Our income assumptions are based on a highly reliable data source and were effectively adjusted downward to be conservative.

- The income data is derived from the Current Population Survey from the U.S. Census Bureau and the U.S. Bureau of Labor Statistics, which labor economists recognize as one of the most reliable sources of earnings data.
- Our assumption of $45,000 mean annual wage income for full-time/year-round employees reflects a downward-weighted statistic based on a three-year average from 2012-2014 when the economy was still recovering from recession. In reality, **2014 wage and salary income averaged $52,000 for eligible full-time/year-round employees and $46,200 for all full-time employees.**
- Third, while there is a noticeable gap between median (50th percentile) wages reported in the Market Analysis and the average (arithmetic mean) values used in financial feasibility study, the two are derived from exactly the same set of income data. For the purposes of calculating aggregate contributions into the Program, the average (mean) wages are the appropriate input, not the median. Furthermore, our model accounted for differences in income by age.

C. *Number of workers enrolled. The feasibility model projects 1.6 million the first year, and more than 4 million workers when rollout is complete.*

The Board and some private industry observers have expressed concerns that lower-than projected-participation rates, either among employers or employees, will undermine the Program.

Given the cost structure of the Program and California's large size, it can be self-sustaining even if a large number of eligible employers choose to sponsor their own plan, or if 50% of employees choose to opt out.

- Much of the Program cost will consist of per-unit costs tied to employer count, employee count, and assets under management. For instance, in Year 5 in the baseline scenario, these costs will account for 69% of total Program costs.
- A large state like California has a generous cushion in terms of employee- and employer-level opt out rates. That is, it would will take a very large share of firms and employees peeling off to reduce the contribution base below the absolute minimum for sustainability.

i) What happens if a significant share of large employers (with more than 100 employees) decides to offer their own plan rather than participate in California Secure Choice?

This concern was highlighted as a "fatal flaw" by PAi.[6] This reflects a common concern that a significant share of employers—especially larger employers--will sponsor their own plans in response to the mandate, and that this will render the Program unsustainable.

Employer-sponsored plans such as 401(k)s and SIMPLE IRAs have the advantage of higher contribution limits and potential employer contributions, though existing offerings for small and medium size businesses have high average fees.[7] Such plans also impose costs and burdens that employers would not face under Secure Choice, particularly related to ERISA. Nonetheless, it is certainly is possible, as well as desirable, that financial services firms will offer high quality, low-cost retirement plans to entice some businesses away from California Secure Choice.

Ultimately, from the point of view of Program finances, fewer employers means reduced employer servicing and account servicing costs. As long as there is a large enough total base of contributing employees across which to spread fixed program expenses (i.e., core administration costs), the Program can be self-sustaining.

- For instance, even assuming that the maximum number of employer remain to be serviced, the minimum threshold for financial feasibility—defined in terms of startup loan payoff by Year 10—is about 1.25 million total active participants in

[6] Michael Kiley/PAi, "Response to the 'Final Report to the California Secure Choice Retirement Savings Investment Board,'" March 3, 2016.

[7] For instance, an industry study found that plans with $1M-$10M in assets had a median expense ratio of 127 bps, compared to 37bps for the largest plans. Deloitte & Investment Company Institute (ICI), "Inside the Structure of Defined Contribution/401(k) Plan Fees, 2013," ICI, December 2014. URL: https://www.ici.org/pdf/rpt_14_dc_401k_fee_study.pdf.

our Feasibility Model. This represents a 20% participation rate among the roughly 7 million employees eligible today.

- To the extent that the number of employers is reduced in this scenario, the active participant threshold is even lower.

It is worth noting that the study conducted for a similar retirement savings initiative in Connecticut—a state with an auto-IRA market that is one-eighth the size of California's—arrived at comparable findings about program viability and the timeframe for paying off startup financing. That study identified $2 billion in total assets as the threshold for self-sufficiency. In California, annual contributions alone will exceed $2 billion even if only 1 million of the currently eligible 7 million workers participate.

Even with the extreme scenario of participation among employers with 100-999 employees dropping to 50%, and no employer with more than 1000 employees participating, the Program will still be financially self-sustaining.[8] Startup financing need will increase from the baseline $89 million (per the corrected Financial Feasibility Study dated March 17) to $116 million—well within the 50% buffer recommended in our revised Final Report—and the payoff period will increase from 6 years to 7, after which participant fees can be reduced to about 60 bps. This assumes full state financing. As noted in our Financial Feasibility study, the startup loan amount and the payoff window can be reduced by increasing account fees by a small amount for the first several years, and/or by sharing some startup costs with vendors in exchange for longer-term contracts.

ii) What happens if employee opt-out rates are higher than expected?

See response to 2A above. We already incorporate a very pessimistic effective opt-out rate into our baseline model. Furthermore, effective opt-out rates would have to approach 66% to have a comparable impact on Program finances as having most larger employers peel off from the Program, described above.

3. Factual Corrections Related to Public Comments on Plan Demographics and Online Survey

The public comment letter from the Securities Industry and Financial Markets Association (SIFMA) makes several mistaken assertions about the demographic data in our study, with the goal of indicating that the eligible workforce is much smaller than the number used in our Financial Feasibility model.[9] In addition, SIFMA cherry-picks from the Online Survey results to

[8] In this scenario, half of employers with 50-99 employees are on-boarded in Year 1, to take advantage of slack capacity.
[9] SIFMA, Letter to The Honorable John Chiang, California State Treasurer, March 2, 2016.

conclude that only a small percentage of eligible workers will actually benefit from the Program. We correct those assertions and provide clarification below.

A. Data on Plan Demographics

- *Size of eligible workforce.* SIFMA cites "6.3 million potentially eligible workers." As the Market Analysis states in the first bullet point under "Key Findings" on page 27, our estimate is 6.8 million. This is based on the 3-year average employment in 2012-2014, per the Methodology section on page 26. As explained above, we used an older count of 6.3 million for the Financial Feasibility model in order to be conservative, and the current eligible population count is closer to 7.2 million, leaving a comfortable buffer.
- *Part-time workers and students.* SIFMA states that "the workforce skews young…. and likely includes a large percentage of part-time employees attending school." In fact, as we show in Figure C-6 on p. 31 of the Final Report, full-time workers make up the vast majority of eligible workers (83%), and part-time workers make up a minority (17%). (However, we assume 25% part-time employment in our Financial Feasibility model in order to be conservative.) In response to SIFMA's concerns, we analyzed CPS data on school attendance among eligible part-time workers. Full-time students make up only 6% of the total eligible workforce.

  At the same time, there is nothing intrinsic about student status that should preclude workers from participating in Secure Choice, except for concerns about reducing the potential number of low-balance accounts that may remain inactive for a few years. If the eligibility age were raised to 20, the share of full-time students would decrease to 4%.
- *Firms with less than 5 employees.* SIFMA asserts that the Final Report "does not appear to exclude the nearly 750k Californians who work for employers with fewer than 5 employees." As we state in the description of our market profile methodology on page 26 of the Final Report, only workers employed in firms with 5 or more employees were included. This data—albeit an older series with lower employment and wage counts, presented in earlier Board meetings—was the basis for the Financial Feasibility analysis.
- *Share of eligible participants precluded from participation by IRS rules*. SIFMA notes that "8% of participants could face income restrictions preventing them from participating in a plan." This 8% refers to two groups of workers: 1) married workers whose spouses participate in an employer-sponsored retirement plan and thus may not be able to contribute the maximum to a traditional IRA (but in most cases, can contribute to a Roth) and 2) and workers whose incomes prohibit them from contributing to a Roth (and in most cases, can elect a traditional IRA instead).

  Our recommendation is that Roth IRAs be offered as the default, with employee choice to opt into a Traditional IRA. If the Board chooses, a Traditional IRA can be offered as the default, with a Roth IRA option. In either case, a much smaller percentage than 8% is likely to be precluded from contributing to a Roth IRA *and* from contributing pre-tax to a traditional IRA—in which case they would need to decide whether to make post-tax contributions to a traditional IRA, or opt out of the Program altogether.

B. Share of Eligible Workers Likely to Benefit from California Secure Choice

SIFMA's assertion that only 15% of eligible workers will benefit is simply erroneous. It seems to be based on a highly selective reading of our Online Survey that ignores not only the general arc of the survey responses, but a large body of existing research on household retirement savings and auto-enrollment.

Indeed, the Online Survey as a whole indicates that there is strong demand for the Program and that a large share of eligible workers will participate. These findings are supported by official data demonstrating that workers are not saving enough, and empirical studies demonstrating that auto-enrollment makes a significant difference in improving retirement savings outcomes.

SIFMA begins its calculations with the statement, "Overture quantifies that 71% of uncovered workers are in fact already saving for retirement." (More precisely, 71% of survey respondents reported that they're saving for retirement; the limits of this data point are explained below.) SIFMA then assumes that the balance—29% of eligible workers—are the only ones that remain to be helped by the Program. Finally, they subtract 14% who reported in one question that they could not save for retirement at all, to arrive at 15%. Both the reading and the math are flawed.

To begin, workers who report that they are saving for retirement are not necessarily referring to dedicated retirement accounts. The Online Survey simply asked participants to estimate their savings rate, not how much was being saved and where. Based on our experience observing focus group discussions, it seems that a significant share of workers believe that they are saving for retirement, but are not actually depositing funds into a dedicated retirement account, much less a tax-advantaged vehicle like a 401(k) or an IRA. Often the funds are deposited in money market accounts, CDs, and other highly liquid vehicles that are routlinely drained to fund gifts, aid to family members, and unexpected household expenses. Whole life insurance policies were also cited as a form of retirement savings.

More importantly, nearly half of American households have no retirement savings, and the median total retirement account balance for working-age American families is less than $3,000, according to the Federal Reserve's Survey of Consumer Finances.[10] The median balance for families with heads age 33-37—close to the median age among workers

[10] Nari Rhee and Ilana Boivie, "The Continuing Retirement Savings Crisis," National Institute on Retiremen Security, March 2015. URL: http://www.nirsonline.org/storage/nirs/documents/RSC%202015/final_rsc_2015.pdf.

eligible for the Program—is just $480.[11] Based on this data, and the methodological issues outlined above, it is safe to assume that Online Survey participants over-estimated their savings rate.

In addition, while most retirement wealth is accumulated through workplace retirement savings programs,[12] California has the second lowest rate of workplace retirement plan access among private sector workers among states in the US.[13]

Finally, the Online Survey—taken as a whole—indicates that most workers *want* to save; that most would participate in California Secure Choice; and that the Program would result in increased saving:

- **73% reported that they would stay in the Program**, in response to a carefully designed behavioral experiment to gauge likely opt-out rates. (Based on empirical studies, likely participation rates will be significantly higher if the Program implements true default auto-enrollment that does not require employee action to begin payroll deduction.)
- **86% were confident that, if offered a workplace retirement plan, they "would be able to set aside some money to contribute."**
- 85% thought that auto-enrollment into a retirement savings plan was a good idea.
- 96% reported that it was important to save for retirement.
- When asked to choose from a range of specific dollar amounts that they could set aside in a workplace retirement plan, only 4% said "I don't think I could save anything."

While it is conceivable that participants are being overly optimistic about their capacity to save, a solid body of empirical evidence confirms that auto-enrollment plans make a huge difference in worker savings behavior. In particular, empirical studies have found that auto-enrollment makes the greatest difference for low-income workers, increasing their participation in offered retirement plans from about 1 in 4 to at least 4 in 5.[14] These are the workers who are most likely to claim economic hardship as a reason for not saving on their own, yet they do end up saving when they have the opportunity to contribute to a retirement account through automatic payroll deduction.

---

[11] Monique Morrissey, "The State of American Retirement: How 401(k)s Have Failed Most American Workers," Economic Policy Institute, March 3, 2016. URL: http://www.epi.org/files/2016/state-of-american-retirement-final.pdf.

[12] While most retirement account assets are held in IRAs, they are mostly the result of rollovers from 401(k)s and other employer-sponsored retirement accounts. See for example Investment Company Institute (ICI), "The IRA Investor Profile: Traditional IRA Investors' Rollover Activity, 2007 and 2008," ICI, December 2010. URL: https://www.ici.org/pdf/rpt_10_ira_rollovers.pdf.

[13] Authors' analysis of the 2015 Current Population Survey/Annual Social and Economic Survey from the U.S. Bureau of Labor Statistics.

[14] Clark, Utkus & Young, op cit.; Brigitte Madrian and Dennis F. Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *Quarterly Journal of Economics*, v116n4, pp. 1149-1187.