Response to STORFI #13-01 – SB 1234/ California Secure Choice Retirement Savings Program

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Introductory notes

I appreciate the opportunity to respond to the Request for Information on the California Secure Choice Retirement Savings Program. I believe that, if properly designed, Secure Choice offers the opportunity to extend the benefits of saving to a broader population and to enhance both the spread of wealth and the retirement security of Californians. On the other hand, as my responses make clear, it is important that the Program be founded in realistic views regarding investment risk and the degree to which a plan like Secure Choice

By way of background, I am a resident scholar at the American Enterprise Institute, a think tank based in Washington, D.C. Before joining AEI, I was the principal deputy commissioner of the Social Security Administration (SSA) and prior to that SSA's deputy commissioner for policy. In 2005, I worked on Social Security reform as an associate director of the White House National Economic Council. In 2001, I was on the staff of the President's Commission to Strengthen Social Security. In addition to my duties at AEI, I currently am serving as co-vice chair of the Society of Actuaries Blue Ribbon Panel to Explore Causes of Underfunding in Public Pension Plans. I have a bachelor's degree from Queen's University Belfast in Northern Ireland, master's degrees from Cambridge University and the University of London, and a Ph.D. from the London School of Economics.

To begin, it is important to accurately assess the scale of the problem. For instance, the RFI states that "Nationwide, nearly half of private sector workers have no access to retirement savings plans at their workplace." Yet according to a 2011 study of tax records by the Social Security Administration, 72 percent of all private sector workers are offered a retirement plan and 58 percent of them choose to participate. Figures showing lower retirement plan availability are based on surveys of workers, who often fail to report being offered a plan even if they are offered and participate in one. A 2011 research paper published by the Investment Company Institute shows that most of the workers who are not offered retirement plans are younger employees who have yet to begin saving or lower-income workers who will receive a relatively high replacement rate from Social Security. Such individuals may be rational in seeking higher wages versus saving for retirement, and employers who hire such employees may be rational in offering them that.

Similarly, one should be careful not to overstate the scale of the retirement saving problem. While some popular studies point to a multi-trillion dollar “crisis” in retirement saving, academic and policy research often shows a more limited problem. For instance, research I published while at the Social Security Administration shows that typical new retirees today have total retirement incomes equal to 185 percent of their average final earnings and 124 percent of their inflation-adjusted average lifetime earnings. Among lower-income households, these replacement rates tend to be even higher. The SSA models project that, while replacement rates will be lower in 2040 than today, typical households will retire with incomes in excess of 130 percent of their final earnings and 100 percent of their CPI-indexed average lifetime earnings.

This is not to say that some Americans have failed to save sufficiently for retirement. Research by University of Wisconsin economist Karl Scholz and his co-authors finds that around 26 percent of people have less retirement wealth than they need, and of those who aren’t well-prepared the median shortfall is around 17 percent (or about $32,000 in retirement savings). There does not seem to be a strong correlation between income and the sufficiency of individuals’ retirement savings. That is, the rich are just as likely to fall short as the poor, although for obvious reasons public policy is more concerned with those who are lower on the income scale and thus most in danger of poverty.

Answers to questions contained in the RFI

2. What investments would you recommend to best meet the goals and objectives of the Program, both in terms of the types of funds and underlying assets, and the style of management (i.e., active vs. passive)?

> The most important factor is investment costs – that is, the percentage of assets dedicated to management fees. A large DC plan, like the federal government’s Thrift Savings Plan, can have essentially zero management costs, which can significantly increase account balances and income generated at retirement.
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> A second factor is simplicity: the federal TSP offers a small number of funds that are easily understood and track market existing indices. These funds make no effort to “beat the market.” This is a wise approach. The Program should not go the route of active fund management, which increases management costs, produces only dubious results, and (perhaps most importantly) shifts a moral/political burden to the government if the plan’s investment returns fail to match the broader market.

3. If you recommend more than one investment option, what would you recommend as the “default,” or automatic, option that would be chosen for participants who do not make an affirmative decision?

I would recommend that participants be allowed to choose between a small number of TSP-style funds or, even more simply, between a small number of portfolios based upon a range of index funds. For instance, a "life cycle" fund that shifts from stocks to bonds might be the default investments, as it would suit most participants and appear reasonable to them. Alternately, low, medium and high-risk portfolios might be added.

To the degree that participants bear investment risk, the Board should consider the level of risk such participants would desire. If participants are predominantly low-earning individuals, it is not clear that they would *want* very low risk investments. Such individuals are already heavily invested in Social Security, meaning that a large component of their retirement income will drive from a program that is low risk but pays a low return (similar to a bond). One advantage of additional retirement saving is that it provides this individuals the opportunity to diversify into riskier, but higher-returning, assets such as stocks.

4. Would you recommend including any insured interest or insured income products? Why or why not? What are the advantages and disadvantages of these products in terms of performance, risks, cost and transparency?

It makes sense to offer such products, as there may be cost advantages to participants to receiving them through the Program rather than (say) cashing out their account and purchasing such products privately. One question (discussed in question 5 below) is the degree to which such products should be required or encouraged.

5. Would you recommend the Program provide a lifelong stream of guaranteed income? If so, how would you convert retirement savings into a lifelong retirement income stream, and what investment product would you recommend to accomplish this objective?

In theory, individuals should seek to annuitize much or all of their retirement wealth; doing so is the most efficient means of insuring against the risk of outliving your assets. On the other hand, the target audience for the Program would already receive most of its retirement income in the form of an annuity (Social Security) and so might desire the opportunity to withdraw savings in the form of a lump sum. Moreover, since the program remains voluntary we must bear in mind the need to make participation attractive.

At the least, the Program should offer annuities, which most DC pension plans do not. (Though see the federal Thrift Savings Plan for examples of how DC annuities might work.) If an annuitization requirement were desired, it might be limited to ensure that the annuity plus Social Security would reach the poverty threshold. Alternately, the Program might offer incentives for annuitization – say, a bonus or a period-certain payment.

7. What recommendations would you make to ensure an effective risk management system is in place to monitor risk levels of the Program and ensure risks taken are prudent and properly managed?

The key to good governance and solid risk management is to align the incentives of different stakeholders. If key stakeholders can benefit from high risk but not be harmed but it, they will (and rationally-speaking, should) push for increased risk-taking. When the party that chooses the level of risk also bears that risk, there will be natural safeguards against excessive risk-taking. This does not mean that every decision with regard to investment risk will be correct, but it does prevent outcomes in which we could *expect* that incorrect decisions would be made.

The RFI notes that "Risk to plan assets should be limited through the diversification of investments" and that the pooled investment must be designed to "provide a stable and low-risk rate of return." The first criterion is easier to define and satisfy than the second. Diversification of assets to create an "efficient" portfolio is relatively straightforward; most diversified mutual funds would at least come close to satisfying this criterion, and a centrally-managed investment pool should have little difficulty in doing so.

However, diversification can eliminate only certain "idiosyncratic" risks that are specific to the companies being invested in. Broader "market" risk, such as the ups and downs of the economy as a whole, cannot be diversified away. Here, the board must make a simple decision regarding the trade-offs between risk and return. It cannot assume, as many state/local pension funds do, that equity risk essentially disappears over long holding periods. It does not: for instance, while the standard deviation of annual returns falls over time, the standard deviation of the end balances of a given risky investment only grows as the holding period increases. The effects of longer compounding periods trump the effects of lower annual investment risk.

This understanding of long-term risk is particularly important if the Board chooses to offer participants guaranteed or semi-guaranteed returns. Simply put, the highest return that a self-financing plan can guarantee to participants is the yield of riskless U.S. Treasury securities. Providing participants with a 7 percent-plus return on par with those projected by CalPERS or CalSTRS would be foolhardy.

On this topic, you might wish to refer to research I conducted while at the Social Security Administration on the cost of guarantees for Social Security personal accounts. While obviously not identical to the Secure Choice program, many of the issues are similar. You also should refer to academic research on guarantees for DC pensions (in particular, see work by Mitchell & Lahance; Smetters; and Pennachi). Also see work by the Congressional Budget Office on Social Security personal account guarantees, as well as CBO and Federal Reserve research on the pricing of liabilities for public sector pensions. This research tends to conclude that the market price of a guarantee is the best representation of its true cost. Having the guarantee provided by the government does not reduce its cost, as the government must distribute the costs of such a guarantee to various stakeholders (say, plan participants, taxpayers, etc.).

Above all, do not allow yourself to believe that the large size or long holding periods involved with a government program allow it to avoid the fundamental choices between risk and return that any other investor faces. The principal advantages of Secure Choice are automatic enrollment and low administrative overhead. These are important advantages and should not be understated. The idea that a large plan can generate to participants high investment returns without commensurate risk is incorrect and, ultimately, could be harmful to the Program and/or participants.

Developing the RFP for the market research, plan design and feasibility study

22. Do you have any recommendations for the type of firm, or firms, that would be most qualified and able to conduct the work necessary for the market research, feasibility and plan design study?

I might envision a two-pronged approach to this aspect of the project. First, for the purposes of plan design, build a team of policy researchers and industry professionals to sketch an outline with regard to contribution levels, contribution escalation, and (importantly) how risk would be spread between participants and the Program. I would not appoint a single firm for the purpose of plan design; each firm tends to have its own embedded institutional culture and viewpoints on such issues, and by contracting with a single firm you are buying into a philosophy of which you may not be fully aware. Moreover, including a team of policy analysts from across the spectrum of views would temper the excesses of any particular party and help build a broader base of support for the program.

For analytical support and market research, however, it may be necessary to appoint a single firm. There obviously are a number of such firms that might be appropriate (Towers Watson, etc.). To be frank, though, I would be wary of contracting with a firm that specializes in actuarial services for public plans, either in California or out of state. These firms have, by and large, bought into a viewpoint in which market risk transferred to the government essentially disappears, which we know not to be the case. There is also, in my view, excessive tolerance of overoptimistic investment return projections. This approach could be harmful to prospects for the Program's success. A firm catering principally to the private sector, preferably with experience on both the DB and DC end, would be most helpful.