Response to California Secure Choice Retirement Savings Program RFI

Email response as an email attachment to: grant.boyken@treasurer.ca.gov
Attn: Secure Choice RFI #13-01

A hard copy (not required) may also be sent to:
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Comments and responses are in **bold**, below.

"The purpose of the study is to determine: (1) the design and structure of a retirement savings program best suited to the needs of the population of eligible California employees; (2) whether the program could be self-sustaining and create no liabilities for the employers or the State of California; and (3) whether the program would meet the necessary legal conditions specified by SB 1234."

It is important to keep in mind that the eligible population will likely be more financially vulnerable and less financially literate than the typical 401(k) or IRA participant. Even if 401(k)s and IRAs worked reasonably well for current participants (they do not, in my opinion), the California Secure Choice target population would need *more* protection from high fees, investment risks, etc. For the same reason, research based on current 401(k) and IRA participants will not necessarily apply to the target population.

"More specifically, the study likely will include: (1) surveys of eligible participants and employers; (2) a review of academic literature on retirement savings participants' needs and behaviors, and on plan design elements that maximize participation and maximize retirement income replacement ratios; (3) legal analysis to determine how to structure the Program in a way that meets legal requirements set forth in SB 1234; and (4) an actuarial analysis to determine whether likely demand and participation would make the program self-sustaining."

There is a tension between the goals of maximizing participation and maximizing income replacement ratios. A plan with a low default contribution rate that allows easy access to funds before retirement will maximize participation. However, most participants will likely fall far short of maintaining their standard of living in

retirement. Conversely, a plan designed to maintain workers' standard of living in retirement will likely have a much lower participation rate.

Since these are competing objectives, they should be assessed separately. That is, the analysis should aim to shed light on the share of the target population likely to participate, the income replacement rate achieved by the average or median (50th percentile) participant, and the income replacement rate achieved by other households (e.g. those at the 10th and 25th percentile) given the range of possible outcomes due to market risk and other factors. It may be desirable to combine these measures into one summary metric, such as the share of the target population whose total income in retirement, with Social Security, is likely to fall below an absolute (e.g. 1.5 times the supplemental poverty line) or relative (e.g. 70% income replacement ratio) threshold. However, any single measure will be somewhat arbitrary: A plan may be optimal by one measure but fall far short by others.

Plan Structure

1. What type of plan structure would you recommend to best meet the statutory goals and objectives for the Program, which include simplicity, ease of administration for employers, preservation of principal and portability of benefits (e.g., a pooled fund with guaranteed interest credited to individual accounts on a regular basis that utilizes a gain and loss reserve? Individually held IRA-type accounts with a variety of funds from which participants could choose? Something else altogether?)

The California Secure Choice plan is supposed to meet two objectives: (1) to "protect principal and offer growth opportunities" and (2) to "provide a stable and low-risk rate of return." These are not interchangeable. Though the first may be a selling point of the California Secure Choice plan, the second matters more in terms of achieving real retirement security for the most workers.

Specifically, to achieve the goal of retirement security for the greatest number of participants, the first objective should be interpreted as protecting participants from cumulative losses—*not* setting a 0% floor on annual returns. As will be explained below, minimizing the cost of the guarantee allows a higher target return. The best way to achieve the second objective is with a pooled and professionally managed fund that uses a gain and loss reserve to stabilize returns credited to notional accounts.

As for offering a choice of investments, the vast majority of workers do not want, nor would they benefit from, individually managed accounts. The exceptions are investors who have no problem seeking out IRAs on their own.

If investment choices are nonetheless offered, these should be low-cost, low-risk investments: diversified portfolios composed of index funds. One obvious model is the Thrift Savings Plan lifecycle ("L") funds, though I believe the asset mix in these funds is too aggressive. It should be understood that the only advantage to lifecycle funds is that younger workers can adjust their savings and retirement plans in

response to bull and bear markets early in their careers (not, as is commonly believed, that cumulative stock returns average out over time).

The separate and somewhat competing aims of setting a floor on investment returns while providing the best possible outcome for most participants are discussed in more detail below.

Guarantee of principal

A guarantee of principal (a 0% floor on investment returns) offers some protection to participants with short careers and those who enroll close to retirement. It may also provide peace of mind to longer-term participants. However, it generally does not offer full-career participants any meaningful protection from losses except in a truly catastrophic investment climate, when the guarantee would likely be suspended or broken in any case.

The cost of a rate-of-return guarantee depends on the investment horizon and whether the guarantee sets a floor on annual or cumulative returns. OECD (2012) has estimated that the cost of providing an ongoing or annual guarantee of principal would reduce final balances after 40 years by 6%. However, the cost would be less than 1% of final balances if the guarantee were binding only after 40 years (that is, if the guarantor paid only if 40-year cumulative returns were negative). It should be noted that OECD cost estimates are intended to show the minimum cost of such guarantees and therefore make unrealistic assumptions, including a very long investment horizon, a very aggressive portfolio allocation and no overhead costs.

The goal of promoting retirement security is best served by focusing on long-run outcomes, and guaranteeing 30- or 40-year cumulative returns is cheaper than guaranteeing annual returns over the same period. However, an ongoing guarantee may be the only feasible option with some plan designs. In practice, however, this type of guarantee is not by itself a very effective way to reduce risk. The Center for American Progress's SAFE plan, for example, which combines an annual 0% floor on investment returns with an 8% cap on returns appears to do nothing to compress the distribution of outcomes across retiree cohorts, though the plan has much else to recommend it, including low fees and higher average outcomes (Davis and Madland 2013). A higher floor on investment returns would do more to reduce investment risk, even for longer-term participants, though it is generally not the most efficient way to do this, especially in the case of an annual or ongoing rate-of-return guarantee.

Since public pensions and other government entities are presumably less risk averse than marginal investors, a government-backed guarantee would be the most efficient and secure way to guarantee returns (Grande and Visco 2010). This option has been ruled out in California. Instead, the California Secure Choice Plan would need to provide a guarantee of principal by investing a share of the portfolio in risk-free investments, by purchasing derivatives, or by requiring investment managers to underwrite the guarantee.

The choice of strategy would likely depend on how funds are managed and invested.

Specifically, it would likely hinge on whether funds were pooled or held in individual accounts; whether funds could be accessed before retirement; whether funds were in managed or passive investments; and whether the investment manager was also the guarantee provider or these were separate entities. For example, the Aspen Institute has proposed a Real Savings + investment strategy for Auto IRAs that would provide a guarantee against real losses by investing a share of an individual's portfolio in Treasury Inflation Protected Securities (TIPS) and the rest in a stock index fund (Mandell et al. 2009). This strategy could in theory be adapted to provide a guarantee of principal using nominal Treasury bonds. However, it would require that the guarantee only take effect after a certain date—presumably requiring restrictions on participants' access to funds before retirement. Alternatively, an actively managed fund could provide a guarantee by purchasing derivatives, but this would presumably give the guarantor some say over the fund's investment strategy and limit investment options (Joustain 2007).

Providing a stable and low-risk rate of return

The goal of providing a stable return can be achieved by investing conservatively (diversifying across assets), using a reserve fund to engage in risk smoothing (diversifying across time), or some combination thereof. Since investing conservatively is always an option for individual investors, the California Secure Choice Plan should aim to do better, using a reserve fund to smooth long-run outcomes around a meaningful target in order to incorporate some of the advantages of a traditional defined benefit pension fund without, however, creating any long-term liabilities. For example, the plan could provide a guarantee of principal while focusing on maximizing the share of participants who achieve a 4% long-run real rate of return (which is the long-run target return for the Canada Pension Plan, a useful model). Though participants could be told the target rate of return and projected outcomes if this target is met, the target is not a guarantee and therefore would not create any long-term liabilities.

The Guaranteed Retirement Account (GRA) plan proposed a 3% real or 3% nominal rate of return guaranteed by the federal government (Ghilarducci 2007) or state governments (Ghilarducci 2012), respectively. Though these plans create a taxpayer liability, many other features of the plans can serve as a useful model for California. In particular, the GRA plan uses a reserve fund, not just to provide the guarantee, but also to smooth outcomes above the guarantee.

In a forthcoming Economic Policy Institute working paper, I estimate that a reserve fund could be used to combine a 5.8% (3% real) guaranteed rate of return with a 6.5% (3.7% real) target rate of return based on the GRA model. Based on Monte Carlo simulations, after the plan had been in place for 100 years, 31% of cohorts received the guaranteed rate of return over their 40-year work lives, 65% received the target rate of return or higher, and 4% of simulations would end in plan insolvency. In the simulations, retiree cohorts were retroactively credited with the guaranteed rate of return over 40-year investment horizons when the plan's asset-to-liability ratio was below 120% (liabilities are based on the guaranteed rate of return); they were credited with the target rate of return when the ratio was between 120% and 200%; and they

were credited with the target rate of return plus any excess reserves when the funded ratio was above 200%.

The requirement that taxpayers incur no liability would require a much lower guarantee in California—ideally, a guarantee of principal—though this might be combined with a slightly higher (4% real) target, which could be adjusted periodically, if necessary. A detail: Since the cost of the guarantee will depend in part on whether workers can access their funds before retirement, it might be a good idea to credit funds that are withdrawn early with a lower rate of return.

Investment Options

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)?

See my response to question 1.

There is little to be gained by giving participants investment choice, with or without fee transparency. It is well known that the vast majority of 401(k) participants fail to diversify and to rebalance their investments. Many instead have an all-or-nothing approach to risk and tend to buy high and sell low. Similarly, there is little advantage to offering participants mutual funds. In my experience, people choose among funds based on historical returns, ignoring fees and dismissing the standard warning that past returns are no indicator of the future, even though most experts agree this is a truism rather than a legal nicety. Meanwhile, few investors are savvy enough to look up the fees they are paying, let alone understand how seemingly small fees could eat up a large portion their retirement savings over time.

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?

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?

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?

An annuity option is essential. However, cost is an issue due to adverse selection. There is also a perception problem: Though people prefer retirement plans that provide a secure lifetime income (Social Security, defined benefit pensions), they tend not to annuitize what they view as savings. Default annuitization, with a penalty for lump sums, should be seriously considered for all or part of the benefit. Ideally, also, accrued benefits should be reported to participants as projected income streams (annuities) rather than lump sums.

6. Would your recommendations require changes to the investment policy parameters in SB 1234? If so, what modifications to the statute would you recommended, and why?

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?

Plan Design and Features

8. What would you recommend as the automatic, or “default,” contribution level for participants who do not opt out, but who do not make an affirmative decision to contribute at a higher rate than the default rate?

A 2-4% default contribution is very low, even with auto escalation. On the other hand, going much above 4% might reduce the number of participants.

9. What options, if any, would you recommend for an automatic escalation feature that increases participants’ contributions over time?

In theory, auto escalation could be designed to maintain the nominal or real value of take-home pay over time. However, most workers are not seeing wage increases, and this may be especially true of the target population. This might suggest a higher initial contribution and less escalation.

10. Are there any other plan design features that should be included (or eliminated) to ensure the plan meets the goals and objectives of the Program? Please explain.

11. What plan design elements would you recommend to minimize pre-retirement “leakage”?

There is a trade-off between limiting access to funds (whether in the form of loans or withdrawals) and encouraging participation in a voluntary system. However, retirement savings that are easy to tap may not help participants save for retirement. Another consideration is whether financial penalties for early withdrawal fall hardest on the most vulnerable participants.

Participants could be dissuaded from accessing funds before retirement by requiring them to go through hoops, such as allowing people to take out loans only for certain kinds of expenses, though that would add to administration costs. My instinct is that making it hard or even impossible to access funds before retirement is the least bad option, unless many small accounts would later go unclaimed. This could be a particular hardship to immigrants, many of whom never collect on Social Security contributions.

Costs and fees

12. Provide an estimate of the ongoing administrative costs and fees of the investment options you recommend and identify the components of those costs and fees.

13. How would you propose to assess fees to cover the costs required to start up the plan? Please identify the components of those costs and fees.

14. How would you recommend the Board ensure transparency of fee and expense information available to the Board and Secure Choice participants including transparency of service providers' relationships or potential conflicts that may increase costs and/or conflict with the interests of plan participants?

Transparency by itself will do little to promote competition and contain costs. Healthcare and financial markets are similar in that transactions involve paying for expertise and it is difficult for the average person to assess either the true cost or value of that expertise.

As noted earlier, I believe there is no particular advantage to offering participants investment choice. That said, if choices are made available, I feel that fees should not only be disclosed, but capped. Furthermore, employers should be required to disclose any business relationships they have with for-profit vendors selected through a clearinghouse and should have a fiduciary duty to employees if they make such a choice on behalf of employees.

Administrative issues

15. What are your recommendations for identifying, and disseminating information to, eligible employers and employees (including employees of nonparticipating employers)? Consider the potential roles that could be played by California's Employment Development Department, any other state agencies or departments, and/or private sector vendors.

16. What are your recommendations for managing enrollment, the receipt and recordkeeping of employee payroll contributions and transactions, and managing rollovers in and out of Program accounts, including potential roles for the Employment Development Department, any other state agencies or departments, and/or private sector vendors?

17. Do you have any particular concerns about, or anticipate any significant challenges with, administering the Program? If so, how would those concerns and challenges best be addressed?

Legal issues

18. What approach would you recommend to demonstrate the Program is not subject to ERISA and that Secure Choice accounts would qualify for favorable federal income tax treatment generally granted IRAs?

19. What further statutes and/or regulations would you recommend be enacted in order to strengthen the legal basis for this retirement savings program?

Establishing a Retirement Investments Clearinghouse

SB 1234 grants the Board the authority to establish an online clearinghouse, and to register for inclusion on the website vendors who offer employer-sponsored retirement plans and payroll deduction plans and who meet specified requirements. The cost of establishing the registration process and the online clearinghouse would be borne equally by registered vendors.

20. Please provide your assessment as to whether there would, or would not, be sufficient interest from vendors to establish an online Retirement Investments Clearinghouse.

21. How would you recommend the Board establish a process to register participants and operate the clearinghouse effectively, efficiently, and in a manner that eliminates or reduces any liability on the part of the Board associated with registering participants and operating the clearinghouse?

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?

23. Are there firms that would be able to successfully conduct all aspects of the work, or is it likely the Board will have to contract with more than one firm?

24. Do you have recommendations about requirements that should be included in the RFP either in terms of the scope of work required or the qualifications of bidders? Strategies for seeking and securing funding for the market research, plan design and feasibility study. By statute, funding to complete the market and feasibility study can only be obtained from the contributions of private individuals, private nonprofit or for-profit entities, from federal sources or from any combination of such sources. The use of State funds or borrowing funds for the study is prohibited.

25. Do you have suggestions and/or examples for the types of organizations that might be able and willing to donate significant funding, or sources of federal funds that might be available for the study?

26. Given that some organizations do not or cannot donate directly to governments, will the fact that donated funds must be placed in a State of California account make it more difficult to raise money? If so, can you suggest funding solutions or arrangements that might help to avoid this difficulty while maintaining the state's independent oversight and jurisdiction over the study?

Timeline for the market research, plan design and feasibility study

Below is a timeline Secure Choice staff presented to the Board at their first meeting. The

Board directed staff to revise the timeline and aim to implement the program and begin enrolling participants in 2015.

27. Do you have recommendations for revising the timeline in a manner that would allow for an earlier implementation date?

Activities

Release the RFI and receive responses from experts and scholars

Prepare RFP for the market and feasibility study

Release RFP and choose vendor(s) to conduct the study

Vendor(s) conduct market and feasibility study

Board considers study recommendations and transmits final report with recommendations to the Legislature, including a request for the authority to make the Program operational if the study's findings are favorable

If the Board recommends making the Program operational, and in anticipation of receiving Legislative authority to do so, develop RFPs for administrator, record keeper, investment consultant and other contracts necessary to operate the program.

Enactment (or failure) of an authorizing statute expressing the approval of the Legislature to fully implement the Program

If authorizing statute is enacted, begin the bidding process for vendors and consultants necessary to administer the Program

Secure Choice begins enrolling participants

Dates

Sept. 2013 - Nov. 2013 Sept. 2013 - Jan. 2014 Jan. 2014 - April 2014 April 2014 - Oct. 2014 Oct. 2014 - Jan. 2015 Jan. 2015 - July 2015 July 2015 July 2015 - Oct. 2015 Early 2016