DECEMBER 7, 2015

AGENDA ITEM 05
INFORMATION ITEM

CALIFORNIA SECURE CHOICE RETIREMENT SAVINGS INVESTMENT BOARD

Market Analysis, Feasibility Study, and Program Design Update

This item will be presented verbally at the meeting.

Attachments

- Attachment #1 – Overture Financial LLC - Project Status Update

California Secure Choice

Secure Choice Retirement Savings Investment Board Meeting

Project Status Update

Sacramento, California

December 7th, 2015

Agenda

I. November Summary Update: 5 minutes

Samir Kabbaj

II. Plan Rules & Procedures: 20 minutes

Nari Rhee

III. Top Investment Options Summary: 20 minutes

Mohammad Baki and Nari Rhee

IV. Feasibility Study Results: 30 minutes

Mohammad Baki

V. Next Steps: 5 minutes

Samir Kabbaj

Appendix

- ✓ Expenses Drivers and Breakdown
- ✓ EDD Estimated Costs & Recordkeeping Cost Drivers
- ✓ Contributors to the Report

I. *November Status Update*

Samir Kabbaj

Overture Financial LLC

November Status Update

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✓ <u>Program Design</u>

- Compiled list of anticipated recommendations related to Plan Rules & Procedures (i.e., employer and employee issues)
- Wrote memorandum summarizing the final investment options

✓ <u>Market Analysis</u>

- Finalized remaining data analysis

✓ <u>Feasibility Study</u>

- Completed financial feasibility modeling for Baseline and Alternative Scenarios
- Conducted stress tests using various demographic and economic assumptions
- Results to be shared today

II. *Plan Rules & Procedures*

Nari Rhee

UC Berkeley Center for Labor Research and Education

Plan Rules & Procedures Overview

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- ✓ Anticipated recommendations for:
  - Plan basics: plan year, plan type, contributions
  - Definitions of Employer, Employee subject to mandate
  - Auto-enrollment mechanics
  - SSN/identity issues
  - Money out: pre-retirement withdrawal, rollovers, retirement payout, lost accounts

  Note: some recommendations require legislative action (amend SB 1234), others involve program-level regulations

- ✓ Driving factors:
  - Simplicity of administration & enforcement
  - Recordkeeping logistics
  - Legal constraints

Plan Basics

Topic	Anticipated Recommendation	Considerations
Plan Year	**January 1-Dec 31** (ERs determine eligibility and begin notifying EEs during 4th quarter prior to each plan year.)	Distinct from qualified plan year
IRA Type	**Default: Roth IRA** -Up to $5,500 <u>after-tax</u> annual contribution (or $6,500 if age 50+) -Tax-free retirement withdrawals -MAGI limit $183K married/$116K single Individual choice to switch to Traditional IRA with recordkeeper flag	Roth IRA does not require participant to file income tax deduction, unlike traditional IRA
Default Contribution	**5%** EE can elect percentage or fixed $ amount per paycheck with no minimum	
Auto-Escalation	Implement at Board's discretion beginning 2nd year of program, in 1% increments up 10% EEs who elect contribution other than default rate: prompted to opt into future auto-escalation	Implement only if operational model allows this process to be coordinated by Recordkeeper

Definition of Employer

Topic	Anticipated Recommendation
Plan Sponsorship Exemption	**At least 1 California resident EE must be eligible for qualified employer-sponsored plan** in order for firm to be exempt from mandate. Consider statutory language giving Board discretion to adjust eligibility rules for ERs that do not offer meaningful coverage to most of their EEs.
Firm vs. Establishment	**ER eligibility determined at firm level.**
Firm Size (5+ EEs)	**Annual determination based on simple look-back rule**, e.g., average headcount per payroll in the 3rd quarter (ending 9/30) is 5.0 or higher. Include only California resident employees count in calculation. (Statute should give Board authority to determine eligibility regulations.) Employers with high 3rd quarter seasonal employment can elect a second test (average headcount per payroll period during 12 months ending 9/30). Exempt if average is 4.0 or below.

Definition of Employer Cont'd

Topic	Anticipated Recommendation
Eligible firms that downsize to <5 EEs	**Continue auto-enrollment/payroll deduction through remainder of calendar year.** The following year, may choose to keep contributing for EEs already enrolled but may not auto-enroll per draft DOL guidelines. Request from DOL ability to grandfather ERs once they enter plan, in order to avoid creating two classes of EEs.
Employment Intermediaries (PEOs, temp agencies, etc.)	**Party that controls payroll (e.g. temp agency) is responsible for compliance.**

Definition of Eligible Employees/ Participants

Topic	Anticipated Recommendation	Considerations
Employees	Eligible for auto-enrollment: **All EEs who are 1) EEs as defined by IRS (receives W-2) and 2) subject to CA payroll taxes** No exemption for PT, short-term, seasonal employees Recommended minimum age: 18 Alternatives: 19 or 20 (no higher, given employment/earnings patterns)	Equity vs plan cost considerations
Owners	**Owners eligible to participate if business falls under mandate.** (Includes LLC/LP partners if they have compensation eligible for IRA contributions under IRS rules)	Impacts on reporting and contribution remission process

Voluntary Participation

Topic	Anticipated Recommendation	Considerations
Employers Not Covered by Mandate	**Allow these ERs to offer Secure Choice IRA to EEs on a purely voluntary basis.** ERs not covered by mandate cannot auto-enroll EEs, per DOL guidelines. Strong recordkeeper control required to prevent ER mis-steps in enrollment.	Small business demand for product
Self-Employed/Independent Contractors	Once the core program is running smoothly, Board should **consider allowing individuals to enroll** through paperless process and automatic debit/ACH.	
Voluntary Employer Contributions	Not allowed for auto-IRA program under draft DOL guidelines and current IRS rules. However, **California policymakers should consider whether the Board should have discretion to establish Multiple Employer Plan (MEP) in the future** to receive voluntary employer match to EE contributions.	Some small business interest in making voluntary ER contributions

Auto-Enrollment & Payroll Deduction Mechanics

Topic	Anticipated Recommendation	Considerations
Active vs Passive	**Passive auto-enrollment**: ER or Recordkeeper notifies EE of auto-enrollment; EE has 30 days to opt out before Recordkeeper instructs ER to start payroll deduction. **Remove signature requirement for enrollment purposes**, keep EE signature as proof of receipt of program info.	Exact mechanics contingent on operational model
EEs Who Change their Mind	**Safe harbor period of 6 months** after initial notification to terminate payroll deduction and receive full refund with no fee	IRA rules provide tax penalty free withdrawal of contributions made each tax year (through April 15 of following year)
Waiting Period	**None; immediate auto-enrollment.** However, Auto-enrollment/opt-out mechanics entail minimum 30 day delay before payroll deduction	

Auto-Enrollment & Payroll Deduction Mechanics Cont'd

Topic	Anticipated Recommendation	Considerations
IRA Contribution limits	**Individual responsible** for tracking limit in relation to income Recordkeeper flags when contributions approach standard limits; issues refund of excess	
Income Limits on IRA Eligibility	Individual responsible for tracking eligibility If ineligible based on income (small % of market): --Elect Traditional IRA (may not be pre-tax if spouse contributes to 401k type plan, depending on income) --Or request refund of contributions/terminate payroll deduction	

SSD/Identity Issues

Topic	Anticipated Recommendation	Considerations
Employer Role	**Normal employment eligibility verification process** Include RFP requirement for Recordkeeper to accept this as adequate	
Recordkeeper & EE Roles	**Recordkeeper electronic validation of identity of new enrollees; contacts EE (not ERs) re invalid SSNs** **EE responsible for taking action to resolve issue -** - correct SSN/name, provide TIN, or opt out--within 45 day period. **If no resolution or EE opts out, Recordkeeper issues refund** directly to EE and instructs ER to stop payroll deduction for that EE.	Problematic SSN process not intermediated by ER

Money Out

Topic	Anticipated Recommendation	Considerations
Early Withdrawals	Draft DOL guidelines prohibit restrictions or penalties; recommend requesting ability to impose requirement to self-certify hardship	Awaiting legal feedback on impact on restrictions at product/fund-level restrictions
Loans	Not permitted under IRA rules	
Rollovers	Regular IRA rules per DOL guidelines – no restrictions	
Default Payout at Retirement	**Board should consider partial group annuity default payout as program matures** and account balances build to levels sufficient for annuitization.	Policy will be contingent on default investment product (E.g., TDF vs Pooled IRA/Reserve Fund vs TDF with built-in income insurance)
Lost Accounts	**Escheat to state.** Board to determine criteria for considering an account lost (balance, # years inactive)	Small, inactive accounts add to program cost

III. *Top Investment Options Summary*

Mohammad Baki

Overture Financial LLC

Nari Rhee

UC Berkeley Center for Labor Research and Education

Top Three Investment Vehicle Options

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No Guarantee

- ✓ Dynamic Asset Allocation
  - ➢ Managed Accounts (with Target Date Funds as fallback)

Soft Guarantee

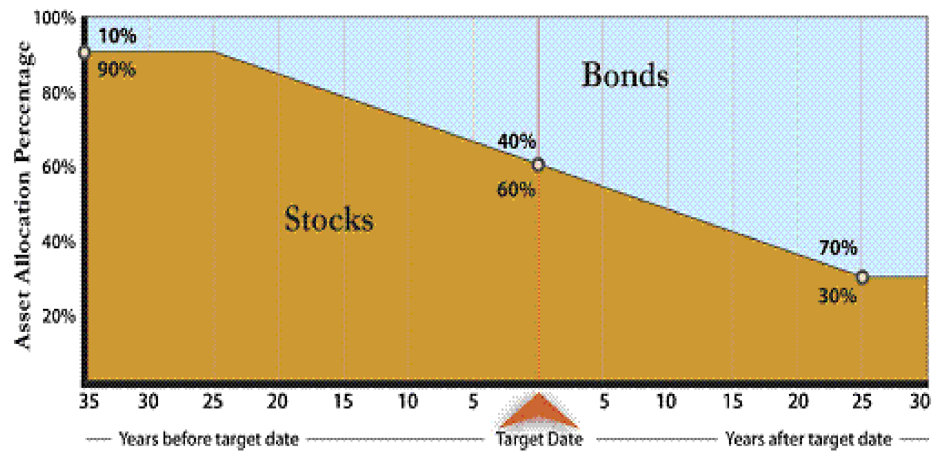
- ✓ Pooled IRA with Reserve Fund
  - ➢ Packaged as Retirement Savings Bond

Insurance Guarantee

- ✓ Variable Annuity with Guaranteed Minimum Withdrawal Benefit (GMWB)
  - ➢ Private insurance product

How Would Target Date Funds Work?

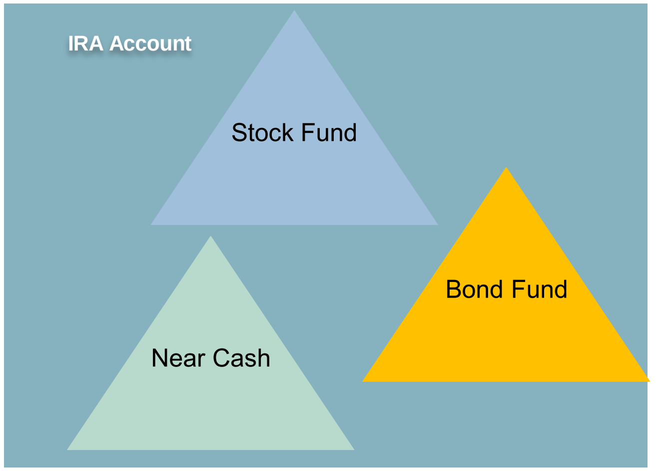
- A TDF investment strategy follows a **"glide path" that gradually decreases investment risk** as a worker nears retirement, by shifting from stocks to bonds.
- The Investment Manager makes the investment decisions for each TDF according to the investment policy for that fund.



- **Program offers series of TDFs** in 5-year retirement date intervals (e.g., "Target 2040" or "Target 2045").
- **Participants are defaulted to the TDF that corresponds to their expected retirement age** based on DOB (validated by recordkeeper).
- A participant can choose a different TDF for a more aggressive or conservative strategy.
- Board may choose to offer a small menu of other investments to choose from (e.g., growth, income)

How Would Managed Accounts Work?

- ✓ **A few investment building blocks (eg, stock fund, bond fund, cash) are used to build key investment strategies,** allowing greater economies of scale.
  - Examples: TDF-like glidepath, low-risk, moderate, aggressive.
- ✓ **For each account, the Investment Manager allocates contributions across building blocks and re-balances the portfolio** according to the strategy selected for that account, aided by software.



- ✓ **Managed accounts are like mutual funds without the fund "wrapper".** They provide more flexibility for customization.
- ✓ **We recommend an initial low risk strategy for the first three years after enrollment followed by a TDF-like investment strategy** based on DOB (validated by recordkeeper), with participant choice to dial risk up or down or switch to a static low-risk/moderate/aggressive strategy.
- ✓ **Participants <u>cannot</u> choose "do it yourself" strategy under managed accounts** by picking and choosing their own investment mix.

Summary of Top Three Investment Options

Default Investment Option	Type	Key Features
Dynamic Asset Allocation Strategy *(Implement through Managed Accounts or TDFs as fallback)*	Conventional DC product	• Individuals bear investment risk • Professional investment management • Asset allocation can be tailored to participant age and risk preferences • Individual ability to dial risk up or down • Can be paired with most insurance products for lifetime income
Pooled IRA with Reserve Fund	State-issued special purpose retirement savings bond (requires enabling state legislation)	• Participants collectively bear investment risk, with "soft" guarantee • Single investment fund overseen by state • Board sets interest rate (e.g., 0-9%) according to investment performance • "Reserve Fund" accumulates from surplus return, covers shortfalls during negative return years. Account balances reduced if necessary. • Can offer in-plan or private insurance annuities for lifetime income • Fund can purchase private insurance
Variable Annuity with Guaranteed Minimum Withdrawal Benefit (GMWB)	Private insurance product	• Individuals bear investment risk until age 55; insurance bears most risks after. • Guaranteed minimum retirement income based on peak account balance between ages 55 and 65 • Can be paired with most conventional DC products.

Participant Experience & Outcomes

Default Investment Option	Participant Experience	Projected Replacement Rate
Dynamic Asset Allocation Strategy *(Implement through Managed Accounts or TDFs as fallback)*	• Managed Account participants see "under the hood" of investment strategy. Account interface needs to be designed to communicate risk in an intuitive manner • TDFs are conceptually simple for participants, but associated risk needs to be carefully conveyed • Daily fluctuations in account values	*With 2% COLA annuity:* 24% average (range 13-36%)
Pooled IRA with Reserve Fund	• Savings bond concept easy to grasp • Participants experience less volatility in account balances over time • No mistakes related to individual-specific asset allocation (e.g., birthdate errors)	*With 2% COLA annuity:* --21% initial full career cohort (range 12-44%) 29% next generation (range 15-67%)
Variable Annuity with Guaranteed Minimum Withdrawal Benefit (GMWB)	• GMWB concept can be difficult to explain/understand • Uncertain retirement income outcomes compared to alternatives with traditional annuity	*With no guaranteed COLA:* 24% average initial benefit (range 13-47%) ~20% average over entire retirement

Replacement rate assumptions: 5% contribution from age 25 to 67. All portfolios modeled with average investment risk similar to a 70% stocks/30% bonds balanced fund. Replacement rate ranges represent 5th to 95th percentile outcomes.

Complexity, Costs, and Risks

Default Investment Option	Administrative Complexity	Cost	Key Risks for Adverse Outcomes
Dynamic Asset Allocation Strategy *(Implement through Managed Accounts or TDFs as fallback)*	**Low** • Managed Accounts facilitate (and can entail) more fine-tuned investment strategy • TDFs simple to run	**Low** • Low investment costs • Main costs are recordkeeping/account management	• Participants may not understand risk embedded in portfolios • Participants may engage in adverse investment behaviors
Pooled IRA with Reserve Fund	**Medium** • Single investment fund • Board plays more active role through crediting rate decision	**Low-Medium** • Lowest possible investment costs • Somewhat higher program admin costs (higher actuarial and legal) • Potentially lower recordkeeping costs (fewer transactions/funds)	• Political risk to state – from Board decisions on crediting rates and investment management
Variable Annuity with Guaranteed Minimum Withdrawal Benefit (GMWB)	**Low-Medium** • Core investment program similar to managed accounts/TDFs • Negotiation of insurance premiums	**High** • 100 bp annual premium beginning age 55	• Depending on behavioral assumptions, participants might pay higher fees/receive lower retirement income compared to alternatives

Summary of Advantages and Disadvantages

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✓ Dynamic Asset Allocation Strategy (Managed Accts/TDFs)

- ↑ *Simple to administer*
- ↑ *Relatively low cost*
- ↓ *Individuals bear market risk*
- ↓ *High volatility in account balance may prompt adverse behavior*

✓ Pooled IRA with Reserve Fund (Retirement Savings Bond)

- ↑ *Easy for participants to understand*
- ↑ *Participants experience lower volatility in account balance*
- ↓ *Requires enabling legislation*
- ↓ *Entails greater political risk*

✓ Variable Annuity with GMWB

- ↑ *Mitigates market risk near retirement*
- ↑ *Participants experience low volatility in basic retirement benefit*
- ↓ *Difficult for participants to understand*
- ↓ *High cost, lower retirement income compared to alternatives*

IV. *Feasibility Study Results*

Mohammad Baki

Overture Financial LLC

Projection Model Overview

- ✓ Projects potential outcome scenarios over 15 years of operation
  - ➢ Number of participants
  - ➢ Cash flow: contributions, distributions, expenses, investment returns
  - ➢ Assets invested in the system
  - ➢ **Expenses as percentage of assets**
  - ➢ Funding requirements

- ✓ Input parameters that define the scenario:
  - ➢ Employee demographics and turnover (based on CPS and Greenwald survey)
  - ➢ Opt-out rate
  - ➢ Default contribution rate
  - ➢ Detailed startup/ongoing expenses for alternative operational models
  - ➢ Participant fees
  - ➢ Economic variables: inflation, wage growth and investment returns

- ✓ **Conservative assumptions used for feasibility testing purposes**. Model supports sensitivity testing and alternate scenarios
- ✓ Methodology incorporates granular actuarial, demographic, revenue and expense modules

Core Assumptions

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✓ Eligible Employees

- 6.3 million employees of which 25% part-time
- Full-time annual pay rate $45,000 with 10% between jobs and 18% annual turnover
- Part-time annual pay rate $20,000 with 25% between jobs and 30% annual turnover

✓ Eligible Employers

- Approximately 285,000 employers of which 90% have fewer than 50 employees
- **Roll-out not to exceed 100,000 employers per year**

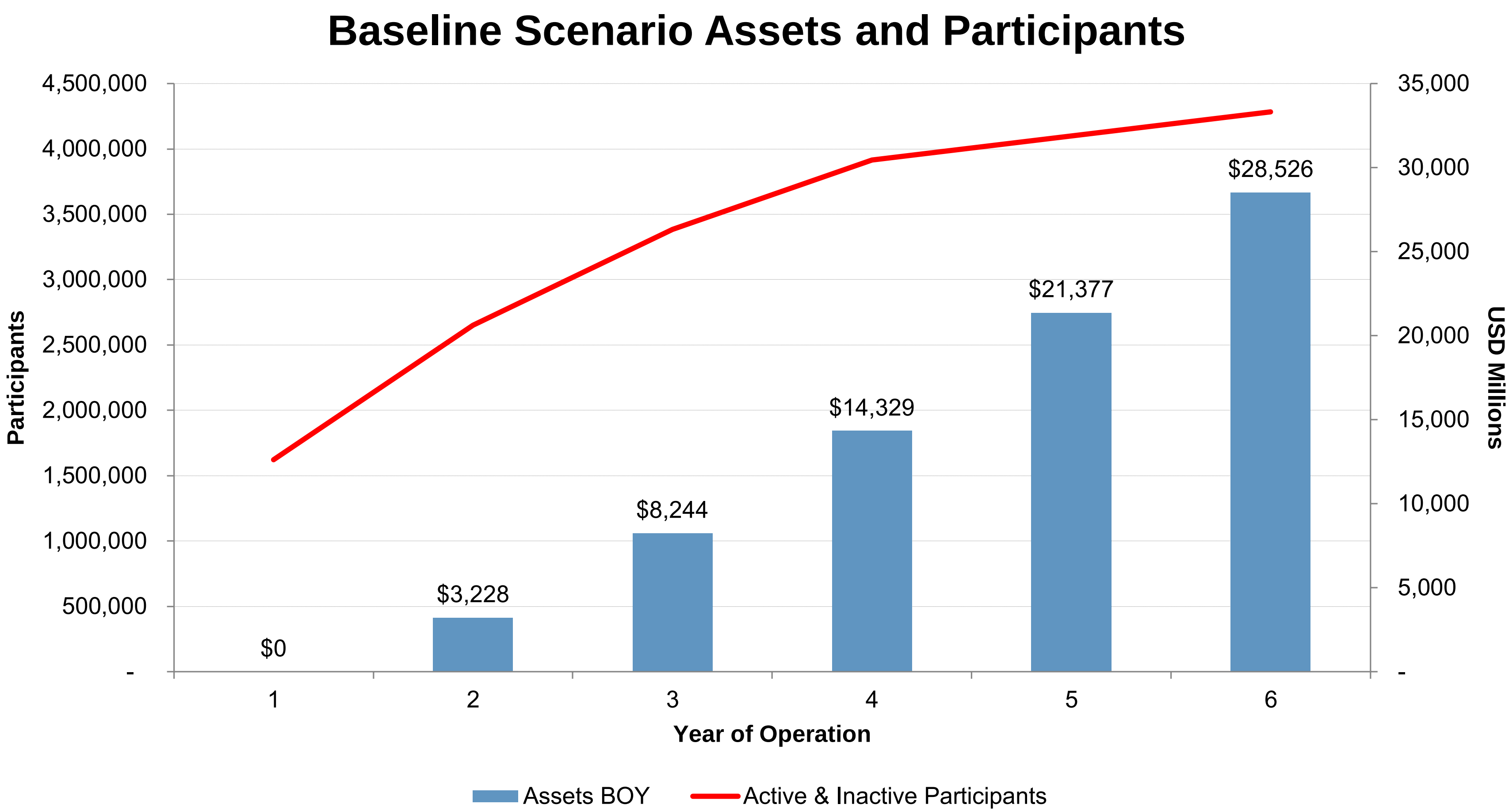
✓ Economic Assumptions

- Long-term inflation: 2%
- Long-term nominal wage growth: 2.5%

Baseline Scenario

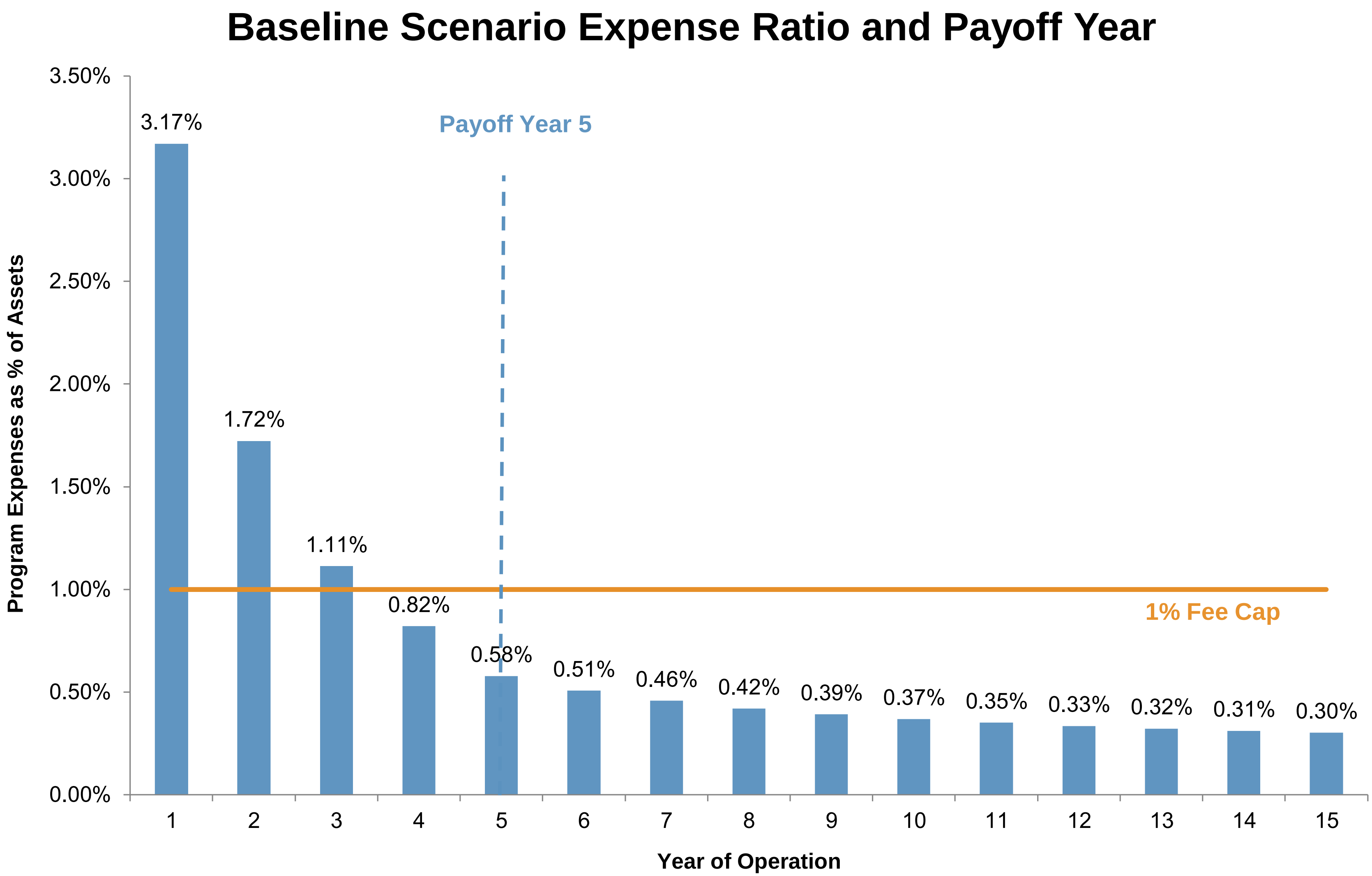
- Participation
  - **Default contribution rate: 5%**
  - **Opt-out rate: 25%**
- Leakage
  - In-service leakage rate (% of assets a year): 1%
  - Percent of job leavers taking lump sum: 50%
  - Total effective annual leakage from plan: 3.5%
- Total Fees Charged to Participants: **1% of assets**
- Program Expenses
  - Direct recordkeeper servicing model with EDD role limited to employer outreach, training and support
  - Description of expense items and assumptions included in Appendix
  - Does not include enforcement costs
- Conservative Nominal Investment Returns: **0% years 1-3, 3% thereafter**

Baseline Scenario Assets & Participants



- ✓ Scale is achieved within the first year of operation
- ✓ First year enrollment only for approximately 11,000 employers with more than 100 CA employees

Baseline Scenario Expenses



- ✓ Program expenses fall below the 1% cap on fees/charges to participants by Year 4
- ✓ Operating deficit during first 3 years has to be financed from future surpluses
- ✓ Funding gap paid off in Year 5 assuming funding cost of 5% per year

Financing Requirements

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- ✓ Startup financing requirement for the Baseline Scenario is **USD 73M**
  - This is equivalent to the amount that the Program would have to borrow in order to cover the revenue shortfalls of the first 3 years, assuming 5% interest
  - This loan would be paid off during Year 5

- ✓ How to finance the funding gap
  - Program secures a startup **loan** or
  - Participants are initially charged **fees in excess of the 1% cap** or
  - Key **vendors fund the gap** by absorbing the operating deficit until the shortfall is paid off. (requires 5+ year contracts and vendors with significant capital wherewithal) or
  - Combination of above

- ✓ Higher participant fees reduce financing need – but shifting the startup fee structure toward account-based fees can be regressive.

Fee on Assets	Monthly Account Fee	Required Financing
1%	$0.5	$44 million
0.8%	$1	$32 million
1%	$1	$15 million
3%	$0	$0 million

Sensitivity Analysis

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	Required Financing (USD Millions)	Payoff Year	Year 1 Program Expenses as % of Assets	Year 5 Program Expenses as % of Assets	Year 10 Program Expenses as % of Assets
Baseline *(5% Contribution; 25% opt-out)*	$73	5	3.17%	0.58%	0.37%
3% Contribution Rate	$129	7	4.78%	0.79%	0.47%
10% Opt-out Rate	$73	5	3.02%	0.57%	0.36%
EDD Servicing Model	$98	5	6.03%	0.56%	0.36%
Adverse Investment Returns*	$72	5	3.17%	0.63%	0.37%

**Sequence of Annual Investment Returns as follows: 0%,0%,-10%,-10%,5%,5%,10%,10%,0%,-15%,5%,5%,5%,5%,5%*

- ✓ **Financing requirements and program expense ratios are very sensitive to the default contribution rate.**
- ✓ Initial program expenses are higher under the EDD Servicing Model because of the higher startup cost estimate of $45 million.
- ✓ The opt-out rate has a small to moderate impact below 50% because key variable costs are tied to the number of participants and the program is large in scale.
- ✓ Because the baseline model assumes that participants are defaulted to very low risk investments during first three years, the impact of adverse investment returns is only seen in later year program expense ratios.

Scenario Analysis

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SCENARIO ASSUMPTIONS

	Expenses Borne by Participants	Contribution Rate	Opt out Rate	Employer Servicing Model	Investment Returns
Baseline	1% of Assets	5%	25%	Direct Recordkeeper	Conservative 1st 3 Yrs: 0%; 3% Thereafter
Pessimistic	1% of Assets	3%	30%	Direct Recordkeeper	Adverse: *0%,0%,-10%,-10%,5%,5%,10%,10%,0%,-15%,5%,5%,5%,5%,5%*
Optimistic	1% of Assets	5%	10%	Direct Recordkeeper	Average 1st 3 Yrs: 0%; 6% Thereafter

SCENARIO RESULTS

	Required Financing (USD Millions)	Payoff Year	Year 1 Program Expenses as % of Assets	Year 5 Program Expenses as % of Assets	Year 10 Program Expenses as % of Assets
Baseline	$73	5	3.17%	0.58%	0.37%
Pessimistic	$129	8	4.88%	0.87%	0.47%
Optimistic	$73	5	3.02%	0.56%	0.35%

- ✓ The default contribution rate is the primary driver as shown in the Sensitivity Analysis slide and explains most of the difference in results between the Baseline and Pessimistic Scenarios
- ✓ The Optimistic Scenario is close to the Baseline Scenario because it has the same contribution rate

V. *Next Steps*

Samir Kabbaj

Overture Financial LLC

Next Steps

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- ✓ <u>Program Design</u>
  - ➢ Review final recommendation
  - ➢ Write final report
- ✓ <u>Market Analysis</u>
  - ➢ Write final report
- ✓ <u>Feasibility Study</u>
  - ➢ Fine tune and write final report

Appendix

- ✓ Expenses Drivers and Breakdown
- ✓ EDD Estimated Costs & Recordkeeping Cost Drivers
- ✓ Contributors to the Report

Expense Drivers and Breakdown

Expense Items	Real Growth Rate	Year 1 USD Millions	Year 1 Percent of Assets	Comment
Internal Staff	10%	$3		Based on CA Savings Plus + 20%
Board Expenses	10%	$0.20		Includes fiduciary insurance
External Legal Services		$0.50		Goes down to $250,000 after Year 1
OE&E	10%	$3		Based on CA Savings Plus + 20%
Investment Consultants		$0.35		Goes down to $250,000 after Year 1
Investment Management			0.18%	
Custodian/Trustee Services			0.01%	
Non-Recordkeeping Startup Costs		$0.75		For two years. Yr 1: System Architecture and RFP. Yr 2: Project Management
Recordkeeping and EDD				See next slide

- ✓ The Real Growth Rate column indicates the rate at which the line item will be increased every year (in addition to the inflationary adjustment described below).
- ✓ After Year 5, flat (i.e., non-percent) expense items are increased by 1.5% (i.e., 0.5% less than inflation assumption) every year.
- ✓ Enforcement costs are not included.

EDD Est. Costs & Recordkeeping Cost Drivers

Recodkeeping Cost Drivers

Annual Cost Drivers	EDD Servicing Model	Direct Servicing Model
Flat Amount (Current USD)	$600,000	$800,000
Per New Employer	$120	$240
Per Existing (Non-New) Employer	$120	$150
Per Participant	$17	$20

EDD Cost Estimates

Cost Item	EDD Servicing Model EDD acts as Intermediary between Recordleeper and Employers and Performs Employer Outreach, Support and Training Functions		Direct Serving Model EDD Only Performs Employer Outreach, Support and Training Functions	
	Startup	**Ongoing**	**Startup**	**Ongoing**
Systems*	$42,000,000	$5,000,000		
Legal		$150,000		
Marketing	$800,000	$400,000	$800,000	$400,000
Contribution Processing	$700,000	$1,800,000		
Call Center	$1,200,000	$700,000	$1,200,000	$700,000
Reserve	*$300,000*	*$1,950,000*	*$100,000*	*$300,000*
Total	**$45,000,000**	**$10,000,000**	**$2,100,000**	**$1,400,000**

**Assumes leveraging and upgrading of existing EDD ACES system. A new dedicated stand-alone system is estimated to cost $28 million more.*

- ✓ The recordkeeping cost drivers are based on the operational workflows presented in the October SCIB meeting and are derived from a proprietary model to be provided under separate cover.
- ✓ EDD data are derived from functional cost estimates provided by the department for the EDD Serving Model, with the following adjustments: exclusion of compliance auditing costs, reduction of legal costs to be consistent with our research, and an additional 20% buffer in the Reserve line item.

Contributors to the Report

- ✓ Rowland Davis
- ✓ Arun Muralidhar
- ✓ BridgePoint LLC
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- ✓ Greenwald & Associates
- ✓ K&L Gates