Capitol Matrix Consulting
*Analysis, Advice, Advocacy*

March 24, 2016

California Coalition for Financial Security
1201 K Street, Suite 1820
Sacramento, CA 95814

Dear Coalition Member,

As requested, this letter provides our preliminary review of the report by Overture Financial entitled, "California Secure Choice; Market Analysis, Feasibility Study, and Program Design Consultant Services." We recognize that there are legal issues and issues regarding implementation and employer impacts that others have addressed. Therefore, our review focuses on the key fiscal issues related to the program.

# Background

Chapter 734 of 2012 (SB 1234)[1] established the California Secure Choice Retirement Savings Program and Trust to be implemented by the California Secure Choice Retirement Savings Investment Board. The program would require employers of five or more employees, not otherwise exempt,[2] to deduct a portion of an employee's paycheck for deposit in a retirement trust to be overseen by the Board. It also authorizes the transfer of a portion of the trust's assets to an administrative fund to cover the operating costs of the program, and restricts expenditures from the administrative fund to less than 1 percent of program assets each year.

SB1234 also specified that the program will become operative "only if the board determines that, based on (its) market analysis, the provisions of this title will be self-

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[1] Government Code Section 100000 et seq.

[2] Governmental employers are all exempt. The wording in the statute is ambiguous, but we believe its intent is to also exempt only those private sector employers who offer another qualified retirement plan.

sustaining, and funds are made available … in amounts sufficient to allow the board to implement this title until the trust has sufficient funds to be self-sustaining." In addition, the Act prohibits the Board from opening enrollment in the program until a subsequent authorizing statute is enacted that expresses the approval of the Legislature."

The Overture report addresses the market analysis and financial modeling requirements of SB 1234. While it contains impressive programmatic and financial detail, we believe there are key areas that deserve additional scrutiny before implementation of the program. These include: (1) important fiscal issues were not addressed in the Overture report, (2) the effect of real world issues on the idealized estimates of income replacement at retirement shown in the report and (3) impacts of important items excluded from Overture's financial modeling on the viability of the Secure Choice program.

## Significant Fiscal Issues Not Addressed In Overture's Report

We have identified the following significant fiscal issues that we believe will need to be addressed by the Board, but which were either not raised or inadequately addressed in the Overture report.

**Insurance requirement.** The Assembly amended SB1234 before returning it to the Senate for final approval by adding Government Code Section 100013, which 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" and specifies that "the funding mechanism shall protect, *indemnify, and hold the state harmless at all times* against any and all liability in connection with funding retirement benefits pursuant to this title." (Italics added for emphasis.)

The Overture report makes several recommendations to minimize investment risks. It also makes several recommendations that the Board seek amendments to the enabling statute for specific purposes. However, it does *not* address the explicit insurance requirement that accounts be protected at all times. Clearly, the requirement was enacted to protect both the participants and the state government and probably the bill would not have gotten out of the Assembly without the provision. This leaves two options prior to implementation:

- *Delete Section 100013*. This would put the issue of the state's risk (and the participants' risk) back in front of the Legislature. At that point, the Legislature could consider whether the measures proposed by Overture are adequate to protect the state from any potential future liability. With potentially tens or even hundreds of billions of dollars at stake, the Legislature would probably need a very high degree of certainty that its risk would be kept to near zero in the proposed program design. In the world of investment, risks near zero normally come at the cost of much reduced rates of return.

- *Price in the costs of insurance or annuitize the entire program.* The wording of 10003 suggests the need for an annually redetermined guarantee for each participant plus a general indemnification of the state. A market feasibility study conducted for a similar program contemplated by the State of Connecticut found that the protection of individual accounts at retirement age could be purchased at the rate of 100-200 basis points per year.[3] This protection would only apply to the account balances at retirement - not to individual years prior to retirement - and thus may not fully comply with Section 100013. However, even this policy would have a substantial impact on the rate-of-return assumed by Overture in its retirement analyses (over 6 percent). As to a policy indemnifying the state, we could not find any insurance product that is currently marketed for that purpose.

In our view, Section 100013 can not be implemented. There is simply no practical way to entirely eliminate the risk to the state from a program like Secure Choice. Moreover, in addition to the legal and investment risks, the program creates a significant political risk. Using Overture's best-case scenario, a worker after a 42-year career with uninterrupted 5-percent contribution rate would receive only 24 percent of her final pay as retirement income from the program, and as shown below, the actual income replacement ratios for most participants will be significantly less than that. To the extent that participants misunderstand this promise and misinterpret the new program as offering a more substantial retirement, future legislatures could come under great pressure to augment the program's retirement income. Mitigating this political risk would require a major public outreach and communication effort about the program.

**Outreach and communication.** In its first four years, Secure Choice will result in over 6 million employees having their pay checks reduced by 5 percent,[4] or having to exercise their option not to participate, or to participate at a lower level. Obviously, to prevent mass confusion and outcry as well as to encourage workers not to exercise their right to opt out, the state will need to conduct vigorous and extensive public outreach and a call center for direct communication with participants and potential participants. Indeed, one of the key themes to emerge from the focus group sessions summarized in the Overture report was the need for extensive outreach.[5] While the report acknowledges this need, the financial modeling assumes only $800,000 in the

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[3] http://www.osc.ct.gov/crsb/docs/finalreport/CRSB_January_1_Report.pdf

[4] While SB1234 does not establish a specific default contribution level, Overture is recommending 5 percent.

[5] For example, on page 53 of the report, Overture summarizes opinions and suggestions of consumer organizations and asset building groups as follows: "*Properly designed outreach and education that addresses the diversity and limited financial literacy of the Program market are important.* This includes working with organizations that understand how best to communicate with distinct markets and communities and drawing lessons from the Affordable Care Act rollout to understand how to promote trust in the Program, given that many low-wage workers have had negative experiences with government and the financial system."

first year and $400,000 ongoing for outreach[6] and only $1.2 million in the first year and $700,000 ongoing to the Employment Development Department (EDD) for a call center (which we understand is intended for employers, rather than employees). Also, the report provides no funding for the requirement that the Board "design and disseminate to employers through the Employment Development Department an employee information packet…(which must) include background information on the program and appropriate disclosures for employees."

The state has recent experience with outreach to, and communication with target groups similar to the target groups for Secure Choice, i.e., lower income, diverse, working populations. Specifically, the state recently implemented the Affordable Care Act program, which targets similar populations. Table 1 displays the initial funding proposals for outreach and call centers for this program (Covered California), its target populations and the costs per targeted individual.

We recognize that outreach to enroll and advise people in health care is different than outreach to advise workers of their options with regard to a new retirement plan. It is also the case that the program will be phased in, which will reduce annual expenses. However, even after (1) accounting for the phase in and (2) assuming Secure Choice outreach and communication could be adequately provided at *one-third* the per-person cost of what Covered California budgeted, the budget for outreach and communications would still be over $25 million per year during the phase in period.[7]

**Table 1**
**Covered California Public Outreach and Communications**

| | **Target Population *a/*** | **Budget *b/*** | **Cost per Targeted Individual** |
|---|---|---|---|
| **Public Outreach** | 4.6 million | $102.6 million | $22.30 |
| **Call Centers** | 4.6 million | $121.0 million | $26.30 |
| **Total** | 4.6 million | $223.6 million | $48.6 |

a/Includes all potentially eligible population, including those potentially eligible for subsidized and unsubsidized coverage under Covered California as well as those eligible for Medi-Cal under both pre-and post expansion criteria. Source: https://www.coveredca.com/news/PDFs/CoveredCA-Enrollment_Projections-9-30-13.pdf, figure 2.
b/. Source: https://www.coveredca.com/PDFs/2013_leg_report.pdf, p.28.

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[6] There is no explanation given why the higher amount is to be available only in year 1 despite the proposal to phase-in the population over 4 years.

[7] Calculation is based on the following: 6.3 million (potential participants) X .25 (average percent of targeted persons included during the first four years) X 48.6 (average cost per targeted person in Covered California) X 0.333 (assumed relative cost per targeted person - Secure Choice versus Covered California).

A strong case can be made that the state should cover these costs: it is a state mandated program, with a broad policy goal that affects not only those who elect to participate, but those who decline to do so. In fact, SB1234 seems to contemplate some up-front state investment before the Secure choice program becomes “self-sustaining” (meaning that all its costs are covered from participants' deposits and investment earnings). Therefore one option would be to seek a General Fund Appropriation to cover the costs of public outreach and communication for all or most of the four-year phase-in period.

On the other hand, if the decision is to fund these costs from program revenues, they should be included in the feasibility analysis. We show how that would impact the sustainability of the program below.

**EDD enforcement**. SB 1234 gives the EDD “the power and duties necessary to administer the enforcement of employer compliance with” Secure Choice. The EDD would be authorized to bill the Board for its enforcement costs. With nearly 300,000 targeted employers in the state, the costs of enforcement would likely be significant. For comparison, Covered California operates a program of outreach to small businesses that costs $16.9 million per year. The Overture report acknowledges enforcement costs but does not include funds to cover them.

**Retirement investments clearinghouse and vendor registration**. SB1234 requires the Board to establish both a Vendor Registration and Investment Clearinghouse on the EDD website. The Act requires that the costs of developing and maintaining the Clearinghouse and Vendor Registration sites and processes be covered by the participating investment firms. Currently, most private sector retirement plans are provided by significant workforces of agents who can explain options to employers and participating employees. If the clearinghouse is intended to fill the role that is currently filled by agents, it will need to be well staffed and adequately budgeted. The Overture report does not explicitly budget for these costs, which would have to be covered under the administrative allocations from assets of the program.

# Overture's Estimates of Income Replacement

Workers contemplating whether to participate in Secure Choice will weigh the loss in current income against the expected replacement income they will receive upon retirement. Overture notes in its report that “(t)here is no consensus on how high the income replacement ratio must be to maintain the same standard of living during retirement as before retirement (but) various studies have suggested that middle class households should target income replacement ratios between 65% and 85%; while lower-income households typically need higher replacement ratios than middle-income households because they spend a larger proportion of their incomes on necessities.”

In its investment analysis, Overture models the effects of different strategies on a hypothetical worker who accumulates assets over a 42-year career, working and contributing 5 percent per year, every year, from age 25 to age 67. Under its preferred investment strategies, Overture estimates that the Secure Choice program will generate lifetime income replacement of about 24 percent of the worker's final-year wages.

While the main purpose of its analysis is to compare results of different investment strategies, Overture also uses a replacement rate in this range (22 percent for a worker retiring at age 65) to illustrate the potential benefits to a typical full-career worker. It combines these benefits with the estimated 37-percent income replacement that this worker would receive from Social Security to arrive at total retirement income equal to 59 percent of wages.

Significantly, the results show that even under idealized conditions, the income replacement ratio for this worker will be below the bottom of the suggested range for middle class families, which in turn is lower than the range considered adequate for lower-income households.

More important, however, is that the actual income replacement ratio for most workers participating in the Secure Choice program will likely be *considerably less* than the 22-percent to 24-percent range shown in the report for most workers participating in the program.

This is because the Overture estimate does not take into account the effects of employment separation, financial emergencies, and other "real life" factors that are likely to affect savings levels under the program. It also does not show the reduced benefits that will accrue to workers who are not covered for a full 42 years under the program - either those who are mid-career when the program commences or those who retire before age 67 because of health or family reasons, or late-career layoff.

## Impacts of Real World Factors on Income Replacement

To show the impacts of less-than idealized conditions on the Overture estimates, we replicated its estimates for a typical employee's wages, inflation, investment returns and other factors over a 42-year career.[8] We then used the same model to evaluate the impact of periods of unemployment, cash-outs, reduced contribution rates, early retirement, investments in low-risk funds, and shorter coverage periods. The results of our analysis are shown in Table 2 and described in detail below.

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[8] The estimates are based on a 25 year old employee who earns $30,000 per year (with annual increases of 3 percent per year), and contributes 5 percent of his annual salary each year until age 67. The accumulated assets are then converted to a group lifetime annuity that has a 15-year certain period and 2-percent annual escalation. The full set of assumptions are shown on pages 74 and 75 of the Overture Report.

**Table 2**
**Income Replacement Generated By Secure Plus *a/***

| | Percent of Final-Year Income Replaced | |
|---|---|---|
| | **5-Percent Annual Contribution** | **3-Percent Annual Contribution** |
| **Overture's Example (42 years of continuous contributions).** | 24.6% | 15.3% |
| **Impact of Real World Issues** | | |
| **Employment breaks of about 20 percent, no cash-outs *b/*** | 19.5% | 11.7% |
| **Employment breaks with 2 cash outs. *b/,c/*** | 14.9% | 8.9% |
| **Early Retirement (age 62)** | 17.2% | 10.3% |
| **Stable fund portfolio (2.5 percent return)** | 9.7% | 5.9% |
| **Impact of Fewer Years of Coverage** | | |
| **30 Years** | 13.8% | 8.3% |
| **20 Years** | 7.6% | 4.6% |
| **10 Years** | 3.3% | 2.0% |

*a*\ Assumes portfolio balance at retirement is converted to a group annuity with 2% annual escalation.
b\ Consistent with average period of separation from the workforce shown in BLS panel study of workers from 1979 through 2013. Assumes a 2-year break at age 29, and 1-year breaks at 33, 35,40,50, 60, and 65.
c\ Same as previous scenario but in addition, participant is assumed to cash out 25 percent of the accumulated account balances at ages 30 and 40.
d\ Participant is assumed to take retirement at age 62 and make conversion of accumulated assets to a group annuity.

**Overture full-career estimate.** Using the assumption shown in the Overture report, we estimate that a worker contributing 5 percent of annual income would accumulate enough assets over a 42-year career to replace 24.6 percent of final year wages at retirement. In today's dollars that would equal about $750 per month.

**Impact of a reduced contribution rate on basic estimate.** In the section of it's report discussing the results of the focus group sessions, Overture reports that many participants indicated that they would be able to contribute *less than* $100 per month to their accounts (for an employee earning $30,000 per year $100 would represent 4-percent of monthly income). Worker and consumer organizations expressed similar concerns about the ability of workers to sustain 3- to 5 percent contribution rates given financial pressures on low-income workers. This is not surprising given the high cost-of-living households face in California, particularly in the coastal regions where rents have soared to unprecedented levels. It is also worth noting that a clear majority of other states that have passed similar legislation are currently specifying default contribution rates of 3 percent. Table 2 therefore displays the results for a 3-percent contribution rate.  It shows that the income replacement ratio would fall to 15.3 percent ($468 per month in today's dollars) for a full-career employee.

**Employment breaks with no hardship withdrawals.** A key reason why the idealized estimate included in the Overture report overstates likely income replacement for most workers is because it fails to account for periods of unemployment or labor force separation that normally occur during a typical worker's lifetime. The Bureau of Labor Statistics' most recent longitudinal survey on work and non-work experiences of baby-boomers from 1979 through 2013 found that a typical person covered by the survey was separated from employment about 22 percent of the time between ages 18 and 48.[9] For workers age 25 and over, the average time was just under 20 percent.  The rate was higher for those with less than a high-school degree (40 percent) or only a high-school degree (23 percent), than for those with a bachelors degree or higher (16 percent).  This is significant because workers eligible for the Secure Choice program tend to have lower incomes and levels of educational attainment.

To approximate the effect of unemployment on accumulated savings at retirement, we assumed that our hypothetical worker is separated from employment for 8 out of the 42 years.   As shown in Table 2, if this worker skips annual contributions during the years of employment separation - but never cashes out any of the funds in the account - the income replacement ratio would fall from 24.6 percent to 19.5 percent ($599 per month) assuming a 5-percent annual contribution rate.  The replacement ratio falls to 11.2 percent ($360 per month) under the assumption of 3-percent annual contributions.

**Employment breaks with hardship withdrawals.** If this worker is forced to make hardship withdrawals during one or more of periods of employment separation, the replacement ratio falls further.  The example in Table 2 shows the effects of two hardship withdrawals equal to 25 percent of the assets in the worker's account.  The first is assumed to occur at age 30 and is for $3,690.  The second occurs at age 40 and is for $6,225.  The combination of missed contributions and the two withdrawals would lower the replacement ratio to 14.9 percent assuming 5-percent annual contributions, and 8.9 percent assuming 3-percent annual contributions.

**Early retirement.** Overture's replacement ratio estimate assumes the worker retires at age 67.  While this is only slightly older than the current Social Security full retirement age, it is over 4 years beyond the average retirement age for all Americans in 2013, which was slightly under age 63.[10]  While some early retirements are voluntary, many

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[9] Based on the Bureau of Labor Statistics national *Longitudinal Survey of Youth 1979*, which is a survey of 9,964 men and women who were ages 14 to 22 when first interviewed in 1979 and ages 47 to 56 when interviewed most recently in 2012-13.  See "BLS New Release (USDL-15-0528), Number of Jobs  Held, Labor Market Activity, and Earnings Growth Among the Youngest Baby Boomers: Results From a Longitudinal Survey." March 31, 2015. http://www.bls.gov/news.release/pdf/nlsoy.pdf

[10] Source: Alicia H. Munnell, "The Average Retirement Age - an Update."  *Center for Retirement Research at Boston College*. March 2015, Number 15-4.

are because of family or health reasons, or because of late-career layoffs and extended unemployment.

Workers forced to retire before age 67 would face reductions in wage replacement for two reasons. First, because of fewer contribution years and less investment returns, they would have less assets in their retirement accounts. Second, the reduced level of assets, when converted to an annuity, would have to cover a longer retirement period - hence a further reduction in annual annuity payments.

As shown in Table 2 retirement at age 62 would reduce the replacement ratio to 17.2 percent of final year's wages. In today's dollars, the monthly payment would be reduced from $756 for retirement at age 67 to $515 for retirement at age 62. Under the 3-percent contribution scenario, the income replacement ratio would fall to 10.3 percent ($309 per month).

**Using stable value funds to avoid reductions in account values.** One of the key provisions of SB 1234 is that individual accounts be protected at all times and that the state be held harmless against liability in connection with funding retirements benefits under the program. As noted previously, we are not aware of insurance products that would fully indemnify the state, but one way to minimize risk would be to limit investments to short-term financial securities, such as U.S. Treasury bills and high-grade corporate bonds. Such an investment strategy would, of course, come at a cost in terms of yield, as rates on high-quality, short-term securities are currently much lower than 2 percent. As shown in Table 2, assuming investment returns for a low-risk portfolio that is equal to inflation (2.5 percent) would reduce the expected replacement ratio for the 42-year employee with constant 5-percent contributions from 24.6 percent to just 9.7 percent. Assuming 3-percent annual contributions, the replacement ratio would fall to 5.9 percent.

**Shorter coverage periods.** Finally, over one-half of the eligible workforce today is over 35 years, and thus will have remaining working careers that are considerably less than the 42 years assumed in Overture's estimates.[11] These workers would have less time to accumulate assets under the Secure Choice program, and thus would have less income replacement at full retirement. Specifically, the bottom panel of Table 2 shows that under the 5-percent contribution scenario, income replacement would range from 3.3 percent ($86 per month) for someone who is age 57 at the time of the program's inception, and thus has only 10 years in the program, to 13.8 percent for someone who is age 37 when the program starts, and thus has 30 years in the program. Assuming annual contributions of 3 percent, the range is from 2.0 percent for someone who is age 57 to 8.3 percent for someone who is age 37 at the time of the program's inception.

**Conclusion.** The 22- to 24 percent income replacement ratio shown in the Overture report is a worthy goal, but is not a realistic expectation for the majority of participants in

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[11] Source: Figure C-2 (page 29) of Overture's final report to the California Secure Choice Retirement Savings Investment Board.

the Secure Choice program due to the varied financial pressures, job separations, and other real-world issues the participants will likely face over their careers. The likelihood that the replacement ratio will be lower is not meant to be an indictment of the program. Indeed any improvement in retirement savings would be a welcome development. However, before implementing a new mandate, it is important that its realistic benefits, as well as costs, be fully understood. Our analysis of real-world scenarios demonstrates that, for many participants in the Secure Choice program, the benefits will be limited, in some cases to a few hundred dollars per month or less.

# Financial Feasibility Study

A key component of the Overture report is its analysis of the financial feasibility of the Secure Choice Program. For this analysis, Overture developed a financial projection model to determine whether the costs associated with implementing and running the California Secure Choice program were within acceptable limits over time, i.e., less than 1 percent of invested assets each year. This cap is consistent with SB 1234. It also reflects the fact that administrative costs in excess of 1 percent will significantly reduce participants' investment returns and retirement savings, and will make the program unattractive.[12]

**Overture's key conclusions.** Based on its financial modeling, Overture concludes "the program is financially viable and self-sustaining even under adverse conditions, with poor investment returns and high opt-out rates." Under its baseline scenario, program costs exceed the 1-percent threshold in each of the the first 4 years, but then fall well below 1 percent in subsequent years as assets in the fund grow. They indicate that financing the overages in the early years would require issuance of debt totaling $89 million, which would be paid back with interest from surplus funds by year 6. Under more pessimistic scenarios regarding contribution levels, opt-out rates and investment returns, Overture shows financing costs as high as $170 million, and the payback taking as long as 10 years. However, in all scenarios it modeled, Overture asserts that the program is viable on a long-term basis.

**CMC review of overture's assumptions.** Based on our analysis, we believe that the basic methodological approach and many of the assumptions used by Overture are reasonable. However, as noted earlier, it has not included funding for outreach education, enforcement and call centers that is adequate for successful implementation of the program. Furthermore, the level of record-keeping costs - a key driver of overall expenses - is well below industry averages for existing 401(k) plans.

**Outreach, education, call centers, and enforcement.** As already noted, the feasibility study does not include key costs for employer/employee outreach, education, call centers and enforcement, which we believe will be crucial to the successful implementation of the program. As we explain above, these costs likely will average $25

[12] We note that the other states considering legislation similar to SB 1234 have imposed lower administrative caps. For example, legislation in Connecticut provides for a cap of 0.75 percent.

million per year or more during the phase-in period, and smaller, though still significant amounts in subsequent years. A key decision for policymakers is whether to cover these costs with a General Fund appropriation, or to "internalize" them by charging higher administration fees, as shown in Table 3.

**Record keeping expenses.** Record keeping expenses are a key factor in the Overture model. In fact, on page 91 of its report, Overture identifies the administrative portion of the Secure Choice program as the largest cost item and biggest determinant of the program's financial feasibility. The Overture modeling assumes that annual costs for record keeping, trust services, and custodial services will be about $32 per participant during the first 5 years of the program. This is about one-half the median rate charged in private sector defined contribution plans in 2015.[13]

Overture representatives indicate that their estimates are based on cost drivers developed by Bridgepoint, a provider of consulting services to numerous large record keeping companies, along with the detailed workflows associated with the record keeping duties under the Secure choice program. We were told that the specific benchmarks used to develop these estimates are proprietary, because they are based on confidential company information on costs.

Generally, Overture indicates that the unit cost drivers they are using reflect a pared down level of record keeping services. For example, they envision requiring use of ACH transfers instead of checks for transferring funds, encouraging use of online services, and limiting paper account statements to once per year.

Because of the lack of specific information on the factors underlying its unit cost estimates, it is not possible for us to directly evaluate them. We can say, however, that they appear to be low relative to reported industry averages - even after making allowances for the pared down level of services envisioned by Overture. Our key concern is that the record keeper selected for the Secure Choice program will experience enormous challenges not normally faced by record keepers for traditional employer-sponsored plans. For example, it will be dealing with over 125,000 businesses with 10 or less employees, many of which lack sophisticated payroll systems or basic familiarity with employee retirement benefits. We would expect many of these firms to be uploading payroll data through a data portal or excel spreadsheet templates. These factors will translate into additional time and staffing demands on the record keeper for addressing problems that will inevitably emerge, particularly, during the phase in period. In addition, the record keeper will be dealing with a diverse population, requiring communications in multiple languages, and often-limited degrees of financial literacy.

Another factor is that, as noted in the Overture report, many of the participants will be part time, seasonal workers, often with limited resources. This will likely translate into

[13] Source: "NEPC 2015 Defined Contribution Plan & Fee Survey: What a Difference a Decade Makes." Ross Bremen, CFA, Partner.

high costs for relating to both tracking employee accounts, processing cash outs, and frequent contribution changes. The record keeper could mitigate some of these costs by placing limits on changes, or by charging user fees for these types services, but such charges would make the program less attractive to potential participants.

Given these factors, and the importance of record keeping costs to the overall feasibility of the program, we believe that the Board should carefully consider the risks associated with higher-record keeping costs prior to implementing the program.

# Impact of Additional Costs On Financial Feasibility of the Secure Choice Program

In this section, we model the effects of both (1) the additional outreach related costs (if paid from program administrative fees) and (2) higher costs for record keeping on Overture's conclusions regarding the feasibility of the Secure Choice program. Table 3 displays the results of our simulations.

The first row summarizes Overture's key conclusions about the costs of the program under its baseline assumptions. It shows that first year costs would represent 3.17 percent of assets, but the cost ratio would fall to 0.76 percent in year 5 and to 0.45 percent in year 10. It also shows that Board would need to borrow $89 million to hold administration expenses charged to participants to less than 1 percent in the early years of the program, and that the program would generate sufficient assets to repay the loan by the 6th year following program implementation.

**CMC findings.** Based on our modeling of additional costs needed for outreach, education, enforcement, a call center, and record keeping, we conclude that if some or all of these expenses were paid for from the program's assets, the outcomes under various scenarios would be significantly *less favorable* than shown in the Overture report. Specifically:

- **Additional costs for outreach and related activities.** If we assume that the state spends $25 million[14] annually in years 1 through 4 and $15 million annually thereafter for outreach, education, and a call center, annual expenses as a percent of assets would jump to 4.75 percent in the first year of the program, to 0.83 percent in year 5, and to 0.48 percent in year 10. The additional expenses would boost the amount of borrowing needed to offset the excess administrative costs (those above 1 percent of assets) to $170 million, and the number of years needed to pay off the loan would increase from 6 to 7.

[14] The $25 million reflects potential funding for outreach, eduction, and call centers - discussed above in the section titled " Significant Fiscal Issues Not Addressed in the Overture Report." It does not include potential costs for enforcement, which could be funded from some combination of penalties, General Fund appropriations, or program assets.

- **Additional costs for record-keeping.** If record-keeping costs come in near the 401 (k) industry average, annual expenses as a percentage of asset would be 4.47 percent in year 1, 1.24 percent in year 5, and 0.67 percent in year 10. The required financing would jump to $368 million, and the payoff of the loan would not occur until year 10.
- **Combined effect.** If both the above-two increases occur, annual expenses as a percentage of assets would increase to 6.08 percent in year 1, 1.32 percent in year 5, and 0.70 percent in year 10. The required financing would increase further to $466 million, and the loan payoff would not occur until year 11.

Finally, when the additional costs are included, the Secure Choice program becomes more vulnerable to adverse outcomes related to other factors modeled by Overture in their sensitivity analyses. As shown in the bottom row of Table 3, if (1) the added costs for outreach and record keeping expanses are included, (2) the contribution rate falls to 3 percent and (3) the opt-out rate rises modestly to 33 percent, program administration costs would jump to 9.61 percent of assets in year 1, and would not fall below the 1 percent cap until year 10. The loan needed to cover these overages would jump to $644 million, and payoff of the loan would not occur until more than 15 years after the start of the program.

**Table 3**
**Impact of Added Costs On Financial Viability The Secure Choice Program**

| | Program Costs as a Percent of Assets In: | | | | |
|---|---|---|---|---|---|
| | **Year 1** | **Year 5** | **Year 10** | **Financing Cost (Millions)** | **Payoff Year** |
| **Overture Baseline** | 3.17% | 0.76% | 0.45% | $89 | 6 |
| **Additional Funding:** | | | | | |
| **Public Outreach, Communication, Enforcement** | 4.75% | 0.83% | 0.48% | $170 | 7 |
| **Record keeping ($64 per participant)** | 4.47% | 1.24% | 0.67% | $368 | 10 |
| **Combined Effect** | 6.08% | 1.32% | 0.70% | $465 | 11 |
| **Combined, Conservative** | 9.61% | 1.97% | 0.99% | $644 | >15 |

**Bottom line regarding Overture's financial projections.** Overture's conclusion that the Secure Choice is viable even under adverse conditions with high opt-out rates only holds if (1) costs for outreach, education, enforcement and call centers are provided from state funds or other non-program sources and (2) record keeping costs come in well below industry averages - an event we consider unlikely.

Even under Overture's baseline assumptions the added expenses we have highlighted would raise fees charged to participants, thereby reducing their investment returns and rate of asset accumulation over time. Equally important, the additional costs would make the program highly vulnerable to adverse results, such as lower contribution rates or higher opt out rates by prospective participants.

## Summary

Our review indicates that the Board will need to address several issues not included in the Overture report, including whether or not to recommend repeal of the insurance/annuity/indemnification requirements in statute (GC Section 100013) and how to budget for outreach, enforcement and a clearinghouse for employers and participants. In addition, our review of the major fiscal issues addressed in the Overture report finds that (1) the replacement income (retirement income) that many participants should expect will be substantially less than the best-case scenario presented in the report - for some less than $100 per year - and (2) the report significantly understates the administrative costs likely needed to ensure the program is implemented successfully.

Funding these costs from program assets raises administrative expenses charged to program participants, thereby reducing their investment returns and accumulation of retirement assets. The additional costs also make the program more vulnerable to adverse developments, such as lower-than- expected participation or contribution rates. For these reasons, the financial projections, and particularly the impacts of the additional cost pressures on the financial projections, should be carefully evaluated by the Board.

Sincerely,

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