California Secure Choice: Lessons in Market Feasibility & Program Design

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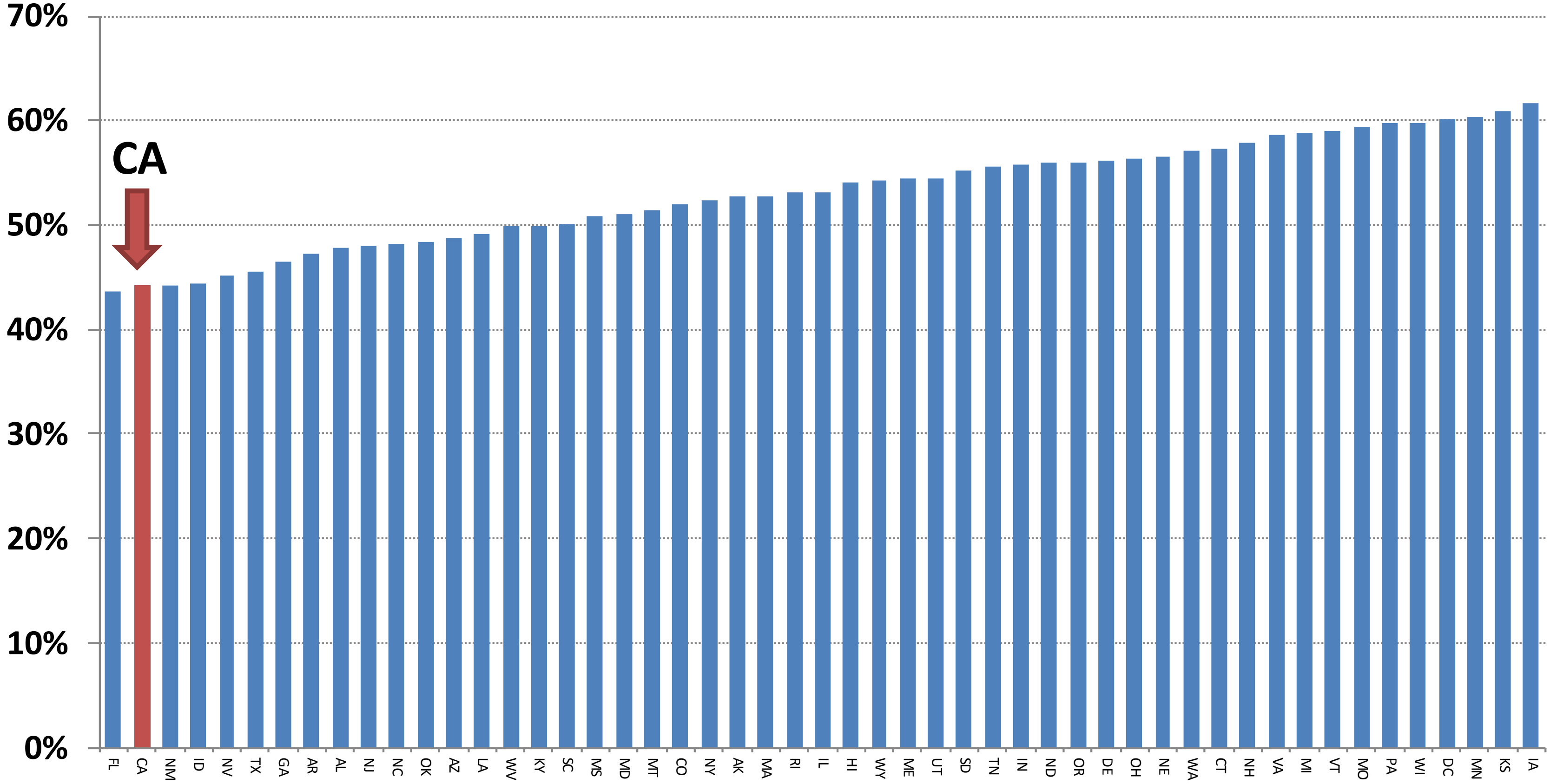
Outline

- Implications of CA Secure Choice Market Analysis for Program Design and Feasibility
  - Opt-out rate, default contribution rate, risk/reward tradeoff.
- Addressing Key Program Design and Implementation Challe
  - Auto-enrollment mechanics, platform design, regulatory issues

CA Near Bottom in Private Workplace Retirement Plan Access



Source: Analysis of CPS ASEC, 2014. Universe is private wage & salary employees age 20-64.

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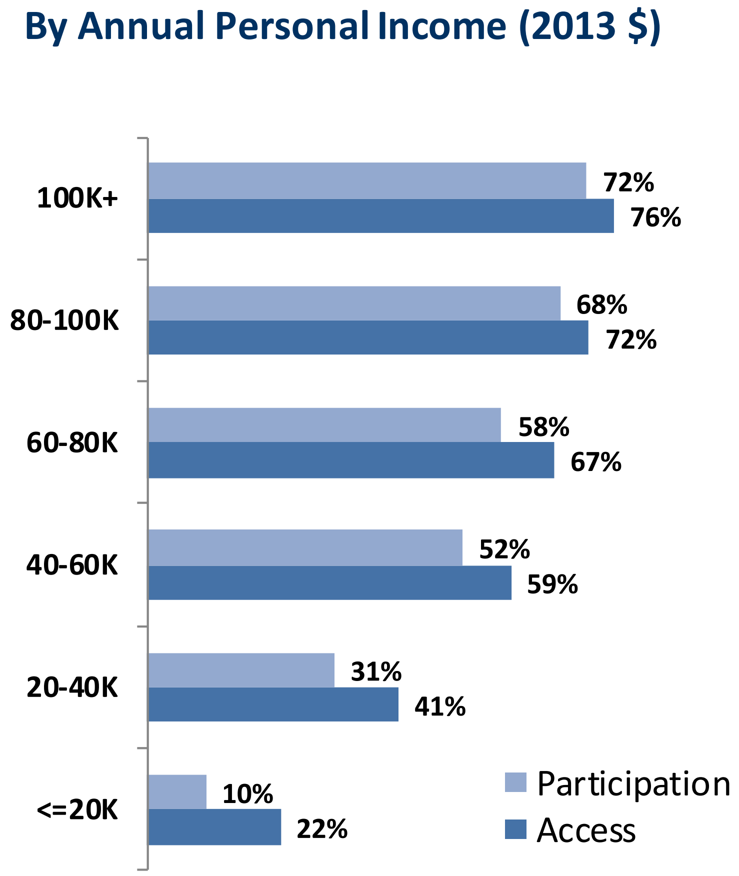
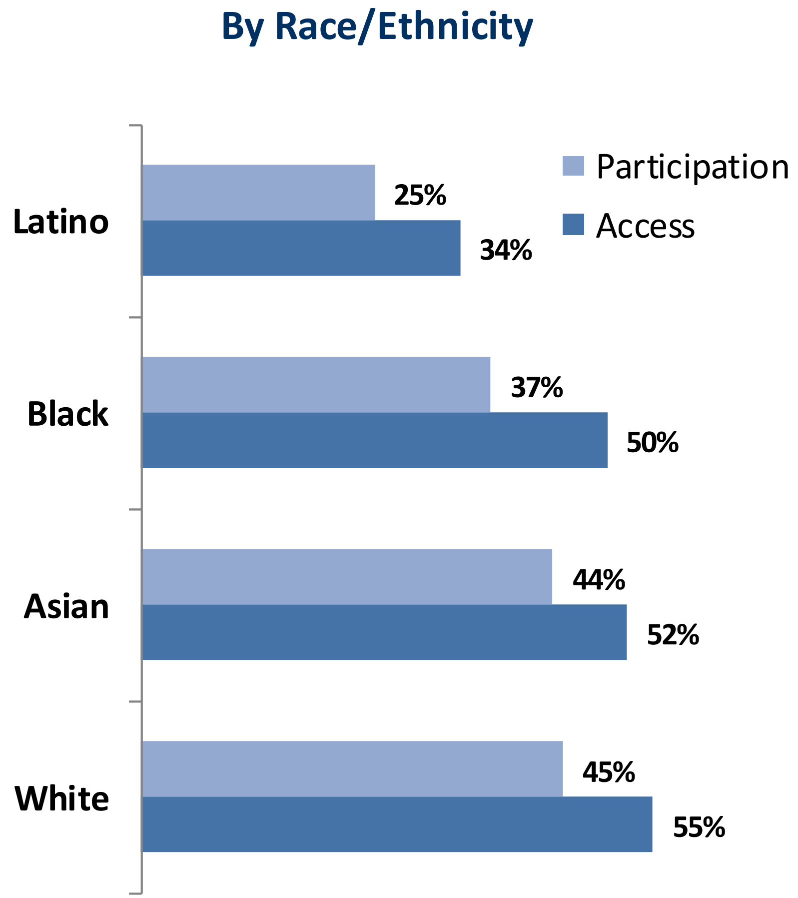
Low-Income & Latinos Have Least Access





Source: Analysis of CPS ASEC, 2010-2014. . Universe is private wage & salary employees age 20-64.

SB 1234/California Secure Choice Retirement Savings Program (2012)

- Mandatory for employers (5+ employees, no retirement plan)
- Auto-enrollment of employees with opt-out
- Individual Retirement Account (IRA)
  - Portable
  - Avoid federal pre-emption under ERISA
- State role:
  - Set default contribution rate; select financial service provider & default investment vehicle; negotiate plan fees
- Possibility of DB features, but only if no liability to state or employers

Consortium Hired by CA to Conduct Feasibility Study

Market Analysis	Are likely participation rates high enough to sustain Program? Participant risk tolerance
Program Design	Default investment vehicle Operational model that minimizes employer burden
Financial Feasibility	Will the Program be financially self-sustaining?

Overture Financial - UC Berkeley Labor Center - Segal Consulting
Matthew Greenwald & Associates - Bridgepoint Consulting - RMD Pension Consulting

Legal Consultant to CA: K&L Gates

Market Analysis

Market Profile

- Age/gender/marital status race, income of eligible EEs
- Tax info for Roth vs. Traditional IRA

Focus Groups

- Greenwald & Assoc
- 6 focus groups across 3 regions
- 4 lower-income, 2 higher-income
- 4 English, 2 Spanish

Online Survey

- Greenwald & Assoc
- 12-15 min survey of 1,000 eligible EEs
- Test opt-out rates for 3% and 5% default
- Risk/reward tradeoff, program features

Stakeholder Interviews:

Business
Labor
Consumer

Characteristics of Eligible Population

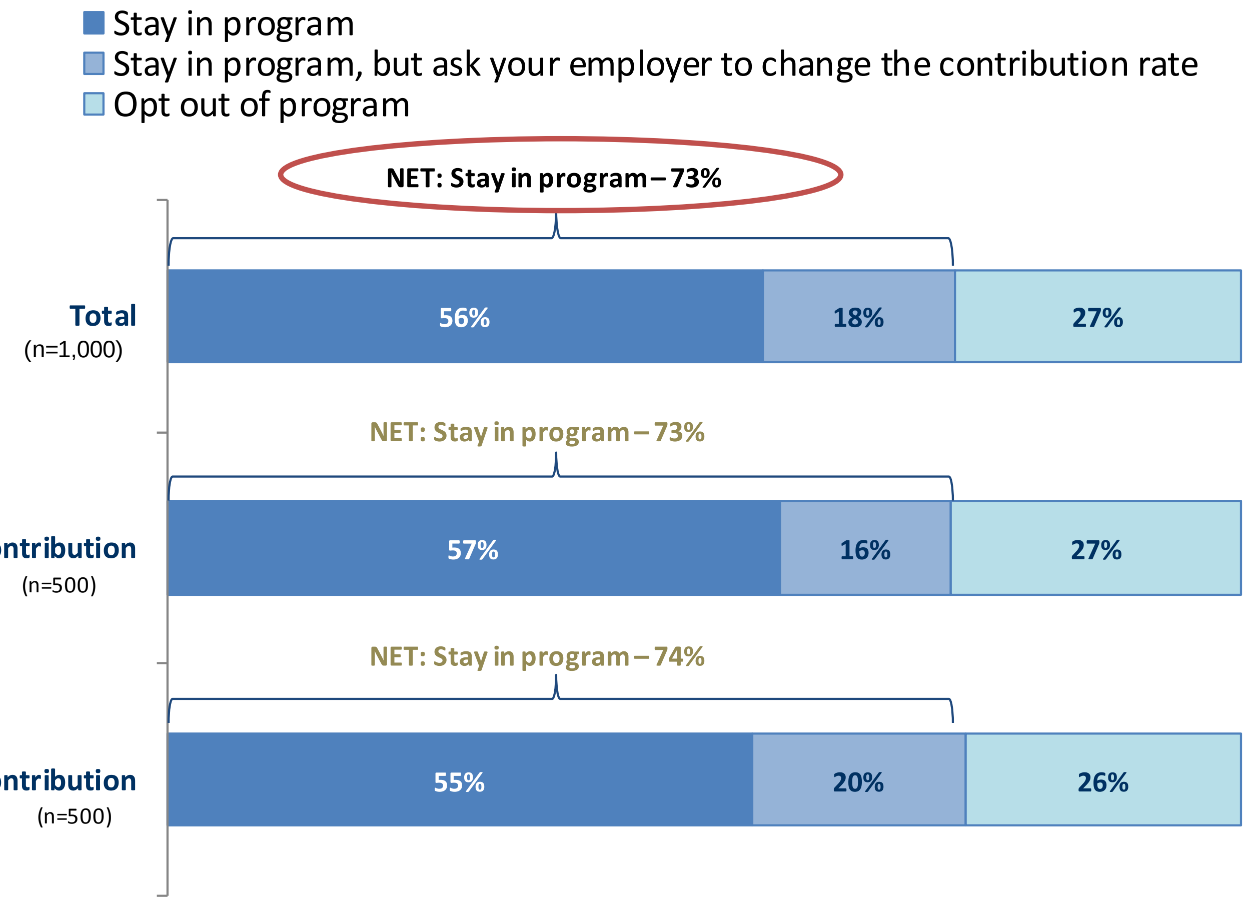
	Key Provisions
Market Size	**6.8M workers in roughly 300K establishments**
Average Wage Income	$23K median, $35K mean
FT/PT Status	83% FT, 17% PT
Firm Size	More than half are in firms with <100 employees
Age	Half are age 35 and younger
Race	2/3 are workers of color. Latinos alone make up nearly 1/2 of potential market.

Key Findings from Employee Focus Groups

1. Even low-income workers want to save
2. Auto-enrollment and payroll deduction are viewed as an easy and convenient way to save
3. Low financial literacy, significant risk aversion among low-income and Latino workers
4. Some distrust of financial institutions and government, especially among low-income & Latino workers

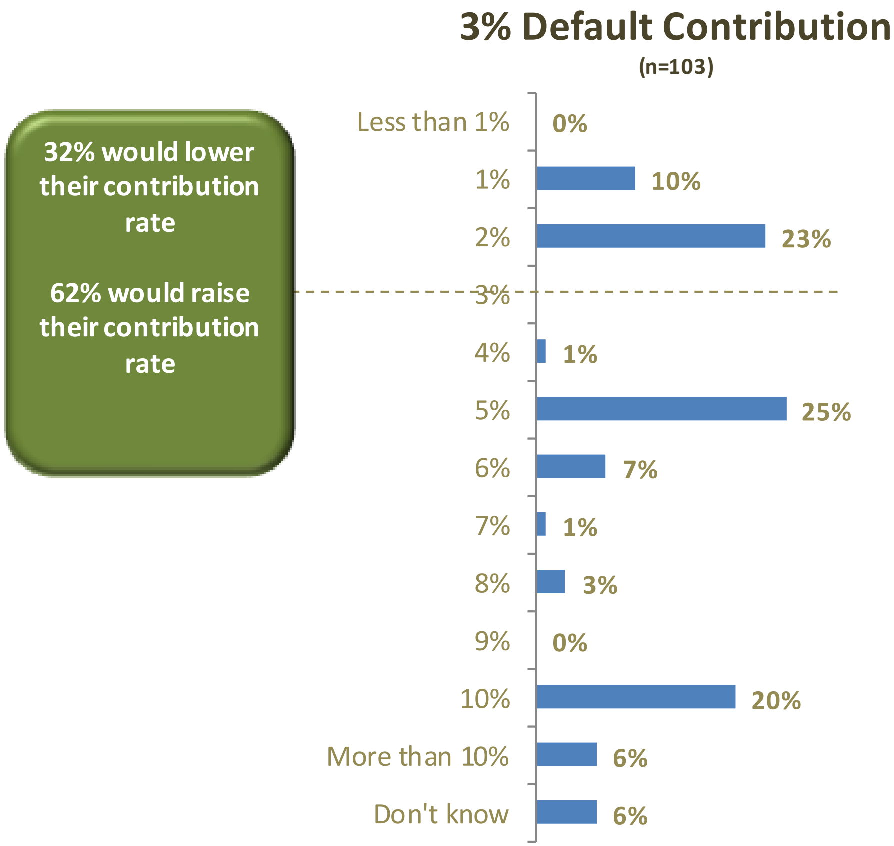
Survey: 3/4 of uncovered workers would stay in California Secure Choice if auto-enrolled

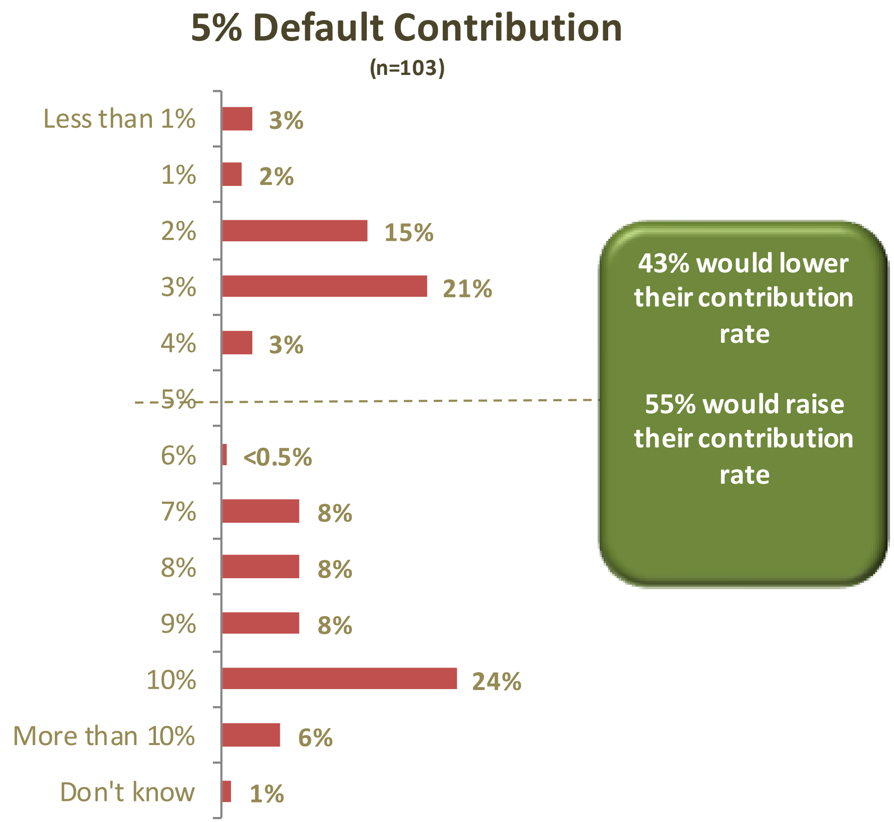
Q1. If you were automatically enrolled in the California Secure Choice program above at (3%/5%) of your paycheck, would you...?



Source: Matthew Greenwald & Associates, "Online Survey of Employees Without Workplace Retirement Plans: Report of Findings," October 2015.

Among those who would ask to change their deferral rate, over half would request a higher contribution rate.



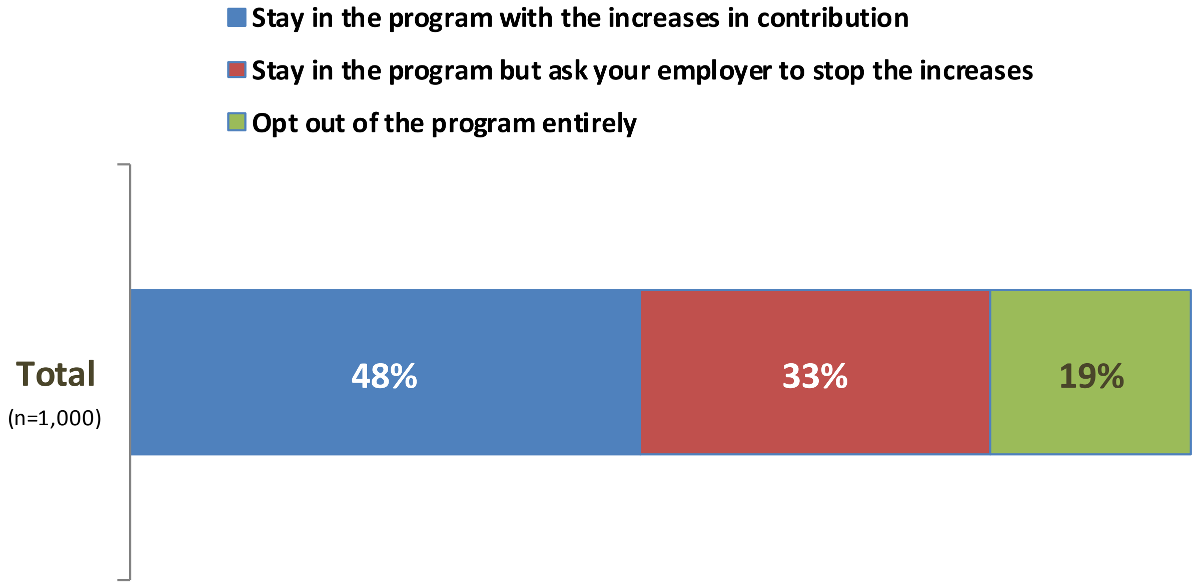


Q1A. What percentage would you ask your employer to change the contribution rate to?

If the program had automatic escalation of 1% annually up to a maximum of 10%, a fifth would opt out and another third would just stop the increases.

- Opt-out rates if the program included an automatic escalation feature are higher for non-Hispanic than for Hispanic respondents (23% vs. 15%).

Q4. Suppose that the program automatically increased your contributions by 1% of your paycheck every year up to a maximum of 10%. Would you…



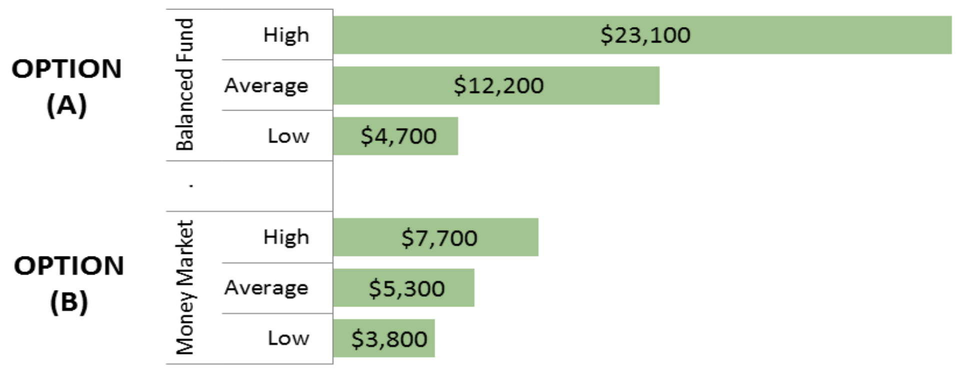
How do eligible workers weigh risk/reward tradeoff?

The retirement savings program could be set up with different fund options. Two examples are described below. Please read both the description and the chart:

A. A "Balanced Fund" that has a mix of 60% stocks and 40% bonds. This is expected to provide significant investment growth over the long term. However, performance will vary a lot from year to year, and there is a 1-in-50 (2%) chance of losing some of the principal (your contributions) after 20 years.

B. A "Money Market Fund," an interest-bearing account that protects the principal. You will never lose your deposit, but interest rates may fail to keep pace with inflation.

Low/Average/High Investment Gains after investing $50/mo for 20 years



Note: Projections are net gains (total account balance minus $12,000 total contributions) based on historical financial market returns. Past performance does not guarantee future results. High = cutoff for top 5% of outcomes. Low = cutoff for bottom 5% of outcomes.

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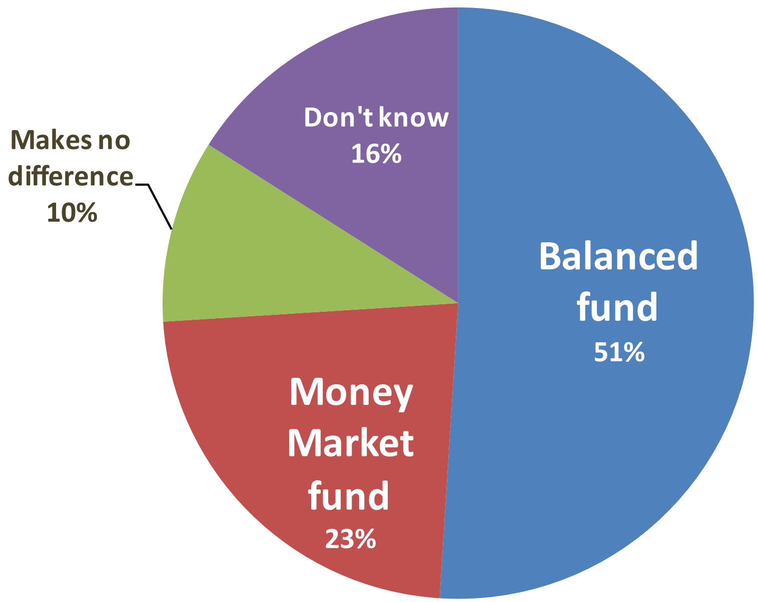
When cost of guarantee is high, about twice as many prefer a Balanced Fund over a Money Market Fund

Q5. Do you prefer to have the money automatically invested in a low-cost fund that is:



Base: Total, n=1,000

Preference for the Balanced Fund increases with education and income.
Preference for Money Market Fund is higher among low-income and Latino workers.

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Implications for Plan Design

- **Default contribution level drives savings behavior**
  - Obvious effects on retirement income adequacy
  - Also biggest driver of plan finances

- **Workers seem to prioritize growth over safety of principal <u>when cost of guarantee is high</u>.**
  - Low-income and Latino workers show greater preference for security
  - Other options for mitigating investment risk?

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Default Contribution Rate Is Biggest Driver CA Secure Choice Program Finances

	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%
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.**
- ✓ Opt-out rates below 50% have a small to moderate impact on expense ratios because much of program cost is variable (based on number of accounts), and CA market is very large.
- ✓ Employer-level opt-out (sponsoring own plan in lieu of auto-IRA) similarly has negligible impact on expense ratios.

CA Is Evaluating Ways to Soften Investment Risk while Preserving Returns

- Default into low-risk investment for first 3 years, then transition into Target Date/Lifecycle strategy
  - Little sacrifice in long-term returns
  - Participants see balances grow through saving before exposure to market risk

- "Pooled IRA": Participant risk-sharing and return smoothing through a gain/loss reserve
  - Modeled after the SAFE Retirement Accounts proposed by the Center for American Progress
  - Reduces risk of loss, while earning returns on moderately risky portfolio

Key Program Design & Implementation Challenges

- Implementing auto-enrollment while minimizing employer burden
- Designing a recordkeeping platform for Auto-IRAs
- Overcoming regulatory constraints designed for retail IRAs
- Enforcement Issues

Strong Recordkeeper Role in Auto-Enrollment Can Minimize Employer Burden

- Register with Recordkeeper
- Upload auto-enrollment data for entire workforce
- Transmit payroll deduction info

- Verify accountholder identity
- Notify EEs/process opt-outs
- Debit payroll deduction amounts from ER accounts (accept bundled data/$ from payroll servicers)
- Direct relationship with employees: contribution elections, ID/SSN issues, refunds

Feedback (EE opt-outs and contribution elections)

Designing a Recordkeeping Platform for Auto-IRAs

- Integrate features of existing platforms for 401(k)s and retail IRAs
  - Individual employee as primary customer
  - Track contributions from multiple employers – simultaneously and over time

- Per-account cost factors
  - If-then complexity
  - Technology/automation vs customer service rep/snail mail

Key Regulatory Issues for State Auto-IRAs

DOL/ERISA

New DOL regs: ERISA safe harbor for auto-IRA with employer mandate

Recognize states' fiduciary role

SEC & IRS

Same flexibility on investment options as 401ks

Governmental Plan vs Investment Company status

Same tax benefits as retail IRAs

Patriot Act

Meet "know your customer" standards without collecting EE signatures, eg, through regular I-9 process and consumer reporting databases

Enforcement

- DOL requirement for mechanism to enforce EE rights under state plans
- What will be the key enforcement protocols? What state agencies will be involved?
  - ER compliance with mandate
  - Individual EE complaints
- Need to examine existing models, capacity in state agencies

Key Takeaways from CA Study

1. **High likely participation rates--**well above threshold for program feasibility
2. **Default contribution rate** drives both savings behavior and program expense ratios
3. **Strong recordkeeper role** needed to minimize employer administrative burden in auto-enrollment/auto-escalation process
4. **Be mindful of regulatory issues** beyond DOL/ERISA