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Lessons from California, Connecticut, and Oregon: How Plan Design Considerations Shape the Financial Feasibility of State Auto-IRAs

By Nari Rhee, Ph.D.

As a growing number of states move toward establishing retirement savings plans for private sector workers who lack access to an employer-sponsored plan, policymakers and stakeholders are very interested in plan cost. Will the program be self-sustaining? Can it charge fees that are low enough to be attractive to participants? What happens if enrollment falls short of assumptions?

States should be encouraged by findings from the financial feasibility studies conducted on state-sponsored retirement plans in California, Connecticut, and Oregon.¹ These states are pursuing an auto-IRA model in which most private employers that do not sponsor their own retirement plan must auto-enroll their employees in a payroll deduction IRA managed by the state. Each state hired consultants to study market demand for the plan, estimate likely participation rates, advise on plan design, and determine whether the plan could

achieve financial self-sufficiency based solely on participant fees. All three studies indicate state auto-IRAs can be self-sufficient while charging attractive participant fees over the long run. Based on conservative assumptions, they project programs will break even in 3 to 5 years, depending on the study, and fully pay off any startup financing in 6 to 7 years.²

At the same time, policymakers need to understand which factors drive program finances, which ones surprisingly do not, and the potential pitfalls that can undermine program sustainability. The studies offer key lessons on both the cost and revenue sides of the equation:

1. **Recordkeeping services, which entail recording and tracking account transactions, make up the biggest and most challenging cost component.** Recordkeeping costs need to be carefully managed through program design that minimizes

complexity. The larger the number of potential decision points and exceptions the recordkeeper must implement, the larger the potential cost. In addition, paper and phone transactions are also much more costly than electronic transactions.

2. **To minimize investment management costs, programs need to take full advantage of their scale by choosing institutional rather than retail investment products and services.** In particular, custom funds (in trade parlance, Collective Investment Trusts or “white label” funds)—have significantly lower expense ratios than off-the-shelf mutual funds and can be tailored to the needs of plan participants.
3. **On the revenue side, the program’s default contribution rate policy—that is, the percentage of an employee’s pay that will be deposited into their accounts unless he or she chooses otherwise—ultimately determines the horizon for the program becoming financially self-sufficient.** The three financial feasibility studies examined in this brief recommend default contribution rates of 5-6%, which will allow states to recoup startup costs within a reasonable timeframe without sacrificing employee participation rates.

Understanding Plan Cost Fundamentals

Each of the three key components of state auto-IRA program cost – recordkeeping, investment management, and program administration—has its own dynamic:

- **Recordkeeping.** Recordkeeping includes signing up new employers, tracking enrollments and opt-outs, conducting due diligence, establishing employee accounts, processing contributions and withdrawals, recording and implementing employee choices regarding contribution rates and investments, generating reports and tax documents, and providing customer service related to these activities. Recordkeeping costs are dominated by unit costs per each employer and each employee account, and constitute by

far the largest cost center during program startup.

- **Investment.** While the Board of Trustees of the state auto-IRA program will set investment policy and exercise oversight, day-to-day management of investment portfolios will be contracted out. Investment management fees are typically charged as a percentage of assets. State auto-IRAs can expect to command low investment management fees if they take advantage of their scale. Because it does not cost much more to manage a \$10 billion fund than a \$1 billion fund, the program’s investment expense ratio—the percentage of assets spent on investment management — can be expected to drop as the plan’s asset base grows.
- **Program administration.** The cost for a state to administer an auto-IRA is generally fixed. This can be defrayed with program revenues and spread across a large participant and asset base. Administration costs include program staff salaries, board expenses, consultant and legal expenses, and fiduciary liability insurance premiums. One-time program startup cost estimates in the three studies range between \$.5 million and \$1.1 million. Ongoing annual program administration costs are estimated to be up to \$1 million in Connecticut, \$1.3 million in Oregon, and \$6.6 million in California, averaging just a few dollars per participant.

Until sufficient assets have been accumulated, program costs will exceed revenues during the startup phase. Because states are reluctant to levy high participant fees, all three studies identify two other options for financing the initial operating deficit. One option is for the state to provide startup funding and/or a line of credit to be paid back with interest once the program achieves positive cash flow. The other option is to have financial service providers subsidize the startup cost in exchange for a longer-term contract, essentially loaning its own capital to the program. States may choose either or a combination of both.

Simplicity and Scale Drive Cost Efficiency

Cost containment is critical for state auto-IRAs because they will start out with a large number of accounts to service, but low average balances on which to charge fees. To minimize total program expenses as a percentage of assets, states must minimize program complexity and effectively leverage economies of scale.

- ***Plans must minimize complexity to contain cost.*** The above studies assume relatively low operating costs based on a few critical factors. First, state auto-IRAs bundle a large retirement savings market, dramatically lowering the marketing costs vendors normally have to recover. Second, the studies assume a simplified retirement savings program in which participants have a limited choice of investments; if-then decisions on the part of recordkeepers and employers are minimized; and electronic communications are maximized in lieu of phone and paper. This is a departure from “rich” 401(k) service models that feature a high level of employee choice and embed significant marketing costs.
- ***Plans must effectively leverage economies of scale to minimize investment and recordkeeping expenses.*** The studies use relatively low expense ratios for investment management—ranging between 17 and 20 basis points—based on the fact that state auto-IRAs can command low fees from institutional investment managers, just like large 401(k)s and public pensions. These are much lower than typical mutual fund fees, which average 67 basis points.

The California study emphasized a corollary mechanism for cost savings, in which investment management contracts are “unbundled” from recordkeeping. That is, a state auto-IRA need not be tied to using a single firm to provide both recordkeeping and investment management expenses. Rather, it can seek out the best provider for each element. This is a model used

in many large 401(k) plans to lower costs and maintain flexibility.

The studies also assume contributions would be spread across a minimal number of funds—e.g., a Target Date Fund series and a principle preservation option. Concentrating assets in a limited number of institutionally managed funds minimizes investment expenses.

In addition, states can also expect to benefit from de facto “bulk discounts” for recordkeeping, as well as simplify administration, by relying on a single recordkeeper.

The Importance of Default Contribution Rate Policy

For a given program cost budget, the biggest factor driving the bottom line is the default contribution rate policy. Behavioral finance research and empirical evidence from auto-enrollment 401(k) plans indicate workers tend to stay with the default contribution rate.³ This means a state auto-IRA’s default contribution rate policy will determine how much workers contribute to the plan each year, and therefore the size of the asset base on which fees are charged. Because of this, all three states found the default contribution rate would have a much bigger impact than any other factor related to deposits and withdrawals—including opt-out rates, account closures, and leakage—on how long their respective programs will take to achieve positive cash flow and pay off any startup financing.

The table below summarizes projections from the financial feasibility studies in California, Connecticut, and Oregon. While the study methodologies differ somewhat across the states, as do participant demographics and the total wage base, they generate roughly similar findings.

To begin, the baseline scenarios using default contribution rates of 5-6% indicate a relatively short horizon for self-sufficiency. In Connecticut, a 6% default leads to breaking even between years 2 and 3 and paying off the startup financing in year 6. In

California, a 5% default leads to the program breaking even between years 3 and 4 and paying off the startup financing in year 7. In Oregon, a 6% default with auto-escalation leads to the program breaking even between years 4 and 5 and paying off the startup financing in year 7.

States can expect to be able to dramatically lower program fees after initial deficits have been repaid. All three states project expense ratios will drop quickly over time, to under 50 basis points in the 10th year of program operation, and continue to decline thereafter.

However, the studies also demonstrate program finances are highly sensitive to the default contribution rate. A 3% fixed contribution rate extends the break-even horizon by 2 years in the California and Connecticut studies. In the Oregon study, a 3% fixed default extends the startup financing payoff horizon by a longer time span—5 years—because the baseline model assumed both a higher default and auto-escalation. With longer timelines, it is possible that states may need to take on a greater share of the financing burden because

private vendors will be less likely to tolerate losses for an extended period.

Opt-Out Rates, Account Closures, and Early Withdrawals Are Not Critical

Contrary to what many believe, program sustainability is not particularly sensitive to significant increases in opt-out rates, account closures, and early withdrawals. This is primarily because state auto-IRA plan costs will be dominated by *variable* costs tied to the number of employers, number of employees, and plan assets. During the startup phase, recordkeeper costs for servicing employers and employees will make up the largest cost center. Conversely, fixed costs make up a minority of program costs.⁴ In most states, an auto-IRA with an employer mandate can expect to achieve an adequately large base of participants and assets across which to spread fixed costs, even with opt-out rates that are significantly higher than expected.

As the largest state in the US, California has an extraordinarily wide margin of error when it comes to employee opt-out. The baseline financial feasibility

State Auto-IRA Financial Feasibility Study Results

	California	Connecticut	Oregon
Baseline Scenario			
Default contribution rate	5%, no auto-escalation	6%, no auto-escalation	5%, auto-escalation to 10%
Fee assumption	1%	0.5%	1.2%
Break-even horizon	Years 3-4	Years 2-3	Years 4-5
Startup financing payoff	Year 7	Year 6	Year 7
Long-term expense ratio	45 bp (0.45%) in year 10	47 bp in year 10	47 bp in year 10
Alternative Scenario			
Default contribution rate	3%, no auto-escalation	3%, no auto-escalation	3%, no auto-escalation
Break-even horizon	Year 6	Year 4	Year 8
Startup financing payoff	Year 9	Year 8	Year 12

Sources: *Overture Financial 2016, Connecticut Retirement Security Board 2016, Center for Retirement Research 2016.*

model for California Secure Choice, which assumes 25% opt-out, shows that 70% of ongoing costs—after all eligible employers have registered and auto-enrolled their employees—will consist of variable costs related to servicing employer and employee accounts.⁵ Furthermore, investment expenses are also variable, based on assets under management. Consequently, even if 50% of employees opt out, the program could still pay back its startup financing by year 7 in the baseline scenario. Its expense ratio would decline to just 50 basis points in year 10. The program could pay back the startup financing by year 10 even with a 70% opt-out rate.

Smaller states also have a comfortable margin for acceptable opt-out rates. Oregon's feasibility study found a 50% opt-out rate and a 50% account closure rate among employees switching jobs will increase the startup loan payoff horizon by one year, but also lead to a smaller program deficit during startup.⁶

Finally, the Oregon and California financial feasibility models show assets lost through account closures and early withdrawals will be dwarfed by incoming contributions and existing assets, blunting their impact on program finances.

Mind Your Program Design

The financial feasibility studies for auto-IRA programs in California, Connecticut, and Oregon demonstrate that over the long term (and in some cases, the short term), they can afford to charge low fees and still remain self-funding. However, this requires states to be vigilant about program design to minimize cost, and to be aware of the ways in which default contribution policy affects the horizon for program self-sufficiency.

States should keep plans simple and maximize electronic transactions in lieu of paper and phone transactions. They should also take full advantage of

low-cost institutional investment management options available to large plan sponsors, for instance by building custom funds that can offer lower costs than off-the-shelf products while meeting the specific needs of plan participants. Finally, states should be aware a default contribution rate of 5-6% will yield the same participation rates as a 3% default, but allows the program to become self-sufficient in a shorter timeframe.

With careful design, states can offer an attractive retirement savings plan to employees who lack access to a 401(k) or pension, and to small businesses that are hard-pressed to negotiate the cost and complexity of employer-sponsored plans.

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End Notes

¹ Overture Financial, “Final Report to the California Secure Choice Retirement Savings Investment Board,” March 17, 2016, <http://www.treasurer.ca.gov/scib/report.pdf>; Center for Retirement Research, “Oregon Feasibility Study Report (Draft),” July 2016, <http://www.oregon.gov/treasury/ORSP/Documents/DRAFT%20Feasibility%20Study%2013JULY2016.pdf>; State of Connecticut Retirement Security Board, “Report to Legislature: Connecticut Retirement Security Board,” January 1, 2016, http://www.osc.ct.gov/crsb/docs/finalreport/CRSB_January_1_Report.pdf

² States have a number of options for financing startup costs and initial operating deficits: startup funding (generically defined as any type of funding whether it be public or private), a line of credit, a subsidy from the recordkeeper in exchange for a longer-term contract, and/or a temporary increase in fees. For purpose of this paper, “startup financing” refers to any of these options.

³ James Choi, David Laibson, Brigitte C. Madrian, and Andrew Metrick, “Saving for Retirement on the Path of Least Resistance,” National Bureau of Economic Research, July 2004; Mark Robinson, “Success of Auto Enrollment and Auto Increase: Using Behavioral Finance to Improve Retirement Planning,” Presented at EBRI Policy Forum, May 13, 2010, <https://www.ebri.org/pdf/programs/policyforums/Robinson0510PF.pdf>; Jeffrey W. Clark, Stephen P. Utkus, Jean A. Young, “Automatic Enrollment: The Power of the Default,” Vanguard Research, January 2015, https://pressroom.vanguard.com/content/nonindexed/Automatic_enrollment_power_of_default_1.15.2015.pdf;

⁴ Connecticut’s study identified \$1B in assets at the feasibility threshold, entailing an estimated \$.5-1 million in fixed program costs and \$4-\$4.5 million in variable costs (Connecticut Retirement Security Board, op cit, p. 38). Immediately after full program rollout, variable costs will make up over 70% of total costs in California (author’s calculations based on California financial feasibility model) and 64% in Oregon (calculation provided by Geoffrey Sanzenbacher, Center for Retirement Research).

⁵ The California study integrates other conservative model assumptions so that a 25% employee opt-out rate translates to an effective opt-out rate in excess of 40% in relation to the total universe of eligible workers. Mohammad Baki and Nari Rhee, “Response to Selected Public Comments Regarding the Financial Feasibility and Market Analysis Studies Conducted for California Secure Choice,” March 23, 2016.

⁶ Center for Retirement Research, op cit, p. 17. The alternative scenario also included a higher account closure rate.