Response to the "Final Report to the California Secure Choice Retirement Savings Investment Board."

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This response to that report is prepared by:

Michael P. Kiley

mpkiley@pai.com

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Comments in this report are offered from the perspective of 33 years of experience designing retirement solutions for small business and the brands that serve small business. For purposes of this report, please note that the author is not licensed to practice law, accounting or any investment role of any nature. Where plan operational comments address investments, those comments are offered from the perspective of a recordkeeper and the operation of those investments in a savings program. None of the comments within are intended to address the topic of investment suitability, performance or risk at the individual, program or system level.

A Word to the Reader

I'm going to apologize in advance for what you are about to experience. The topic of designing and implementing retirement systems for a population of customers, community members and stakeholders can seem complex. Writing to the topic from one perspective – provider, participant, regulator, etc… is difficult enough. In this work, I'm trying to address the more important aspects of the proposed program from the perspective most affected by or invested in various design decisions. The result is a work that is rich in information supported by examples and nearly completely lacking in elegance. I have provided recommendations at the end that I believe are in the best interests of all. Thank you for your patience. Thank you for the opportunity to contribute to an important effort.

Executive Summary

The California Secure Choice (CSC) initiative is a breakthrough effort on a difficult challenge.

It represents an opportunity to move the public private retirement readiness partnership forward in a transformational way. Given the current status of Federal retirement policy and the effort put forth by the contributors to the California Secure Choice initiative – it is appropriate to think of this effort as national in scope. Its effect is certainly being felt that way.

California Secure Choice will achieve the goal of increasing savings participation for over 50 million American workers – only a portion of whom are in California. The payroll and retirement industry response to CSC has never been localized to California. It has always included the element of national scope. Even the term "Secure Choice" is becoming a recognizable industry and policy term – meaning a state workplace retirement savings initiative.

There is a lot of opportunity to get a number of things right in the execution of California Secure Choice. There are very few opportunities to get any design decision monumentally wrong. Those opportunities are very easy to recognize and largely have been recognized by the Board to date. There are opportunities to move the topic forward dramatically – and the market along with it – to the benefit of workplace savers across the nation. It is hoped that those opportunities are seized here.

The Overture Financial report is very well done. This is a big subject with a lot of layers. I admire what they've accomplished given the scope of the topic. My comments here are designed to address specific significant areas of the report with which I disagree as well as to provide suggestions for a path forward.

The Right Way to Think About This Challenge

Most of the conversations that I've witnessed or participated in regarding California Secure Choice or programs like it are plagued by the same mistake the retirement industry has made for decades.

We keep the conversation focused inward and too small. What is the right investment? Plan design? What products and services do **we** have to match up to the need?

The fact is that retirement readiness is an issue that retirement solutions like CSC address for the entire economy, not just the buyers and suppliers in the retirement industry.

In simpler terms, CSC is designed to address the gaps in retirement readiness for 7 million individuals with an average annual household income of $25,000 per year – a nearly $175 billion dollar economic impact. In overly simplistic terms, if CSC fails to deliver success, it could be predicted that those 7 million individuals will drop down to social security incomes of less than half of that $25,000 value. That's a nearly $90 billion reduction in consumer behavior. (Please pardon the oversimplified math.)

Even for the world's 7th largest economy – that's a big impact. Working together, we can keep that $90 billion growing California.

If we keep the conversation small and focused inward, we will miss a world of opportunity to work with the parts of the economy that are interested in that $175 billion opportunity.

The same business community that doesn't want to lose a $175 billion market or face the burden of supporting 7 million unfunded retirees – is looking for a solution that facilitates success in an outsourced solution at a reasonable cost. The market has that to offer.

The California Secure Choice Program Will Be a Success if Success is Defined

The CSC has already been impactful. Judged by the number of states that are initiating similar actions, the CSC is at the center of a very necessary movement to improve retirement outcomes.

The mandate contained within the legislation opens markets.

The definition of success needs to be determined before a successful program and launch can be defined and implemented. Unfortunately there is the potential for significant misalignment between the way the program is designed and the success it is projected to enjoy.

A determination needs to be made whether the goal of the CSC is;

A) Provide a low cost safety net solution for employers and their employees who desire a low cost low risk workplace savings solution OR
B) Build a best in class solution that gathers significant participation and assets.

Either path will produce a successful outcome but it is imperative that this decision precedes any design or implementation decisions.

The Fatal Flaw in the Report

A word of caution on a fundamental assumption on workplace retirement savings.

There have been many policy discussions that predate the CSC initiative that are predicated on the belief that the existing workplace savings industry or 401k industry lacks the ability, capacity, desire or product to meet the needs of the employers and savers targeted by Secure

Choice. It is a mistaken presumption that poses a significant threat to the CSC initiative. The workplace savings industry has had affordable options available for years.

What has been lacking is market demand that makes it possible to profitably drive those products and services into the marketplace. Small business has any number of present day challenges – taking on "future" challenges is typically not in the time or financial budget. The retirement marketplace has evolved the ability to outsource the significant functions that go along with hosting a workplace savings solution for employees. The market has not yet figured out how to get that model adopted profitably. The mandate in California Secure Choice closes that gap simply and is an important step toward success for all stakeholders.

One of my greatest concerns with the final report as presented is the assumptions it makes - and the expectations it creates - around how many savers/subscribers will join the program.

It is my belief that the California Secure Choice program will enjoy enough subscribers (account holders/savers) to be viable – but I think the assumptions of utilization need to be adjusted downward – significantly. As an example, the over 100 life rollout assumption assumes that greater than 50% of the current non plan sponsor market share will go to California Secure Choice. Based on three decades of working with plans and employers in that marketplace, I believe that assumption is 2 to 5 times too high. Existing market relationships will efficiently address 80% of that marketplace when the implementation phase begins. The over 100 life market is a highly desirable market for private sector firms that serve the small business marketplace. The market is already forming campaigns to serve employers affected by the anticipated mandates with attractive solutions.

The report does not provide enough information or examples of existing programs that will compete with CSC. Nor does it do an adequate job of differentiating the product utilization projections for the two significant fund paths illustrated – "Balanced Fund" vs. "Pooled Fund with Reserve". A balanced fund option is a much more attractive option in the marketplace and will enjoy a significantly different level and nature of uptake in the marketplace. Within the report it is called out that while "investment choice" was third on the list of important features and attributes – more than 70% of people surveyed would choose a balanced fund over a pooled fund. The market will have fabulous options for that 70% if CSC goes the Pooled/Reserve route.

If the California Secure Choice Board is challenged to carry the burden of connecting with 7 million potential workplace savers but is only able to capture 10% of that population – the impact on the program could be devastating. I believe the projected utilization of the program is far higher than what will actually be experienced and it puts the proposed program at risk. Program launch strategies and attendant costs need to be aligned and managed carefully.

The Danger of the Pooled Account with Reserve

As a recordkeeper and savings program designer I am very concerned about and disagree with the notion of using a Pooled Fund with a Reserve for Gains and Losses. That type of structure in an IRA based program poses some significant challenges and risks. The following are some operational considerations that the Board will face – none of these considerations is an easy pill to swallow.

The most significant issue the Board would need to decide is a policy on how distributions would be processed. The choices would be as follows – each with its positives and negatives.

Path One – Limit Distributions to once per year. Only pay out benefits once a year when reserve determination is made. In limiting access to funds, one might think this will have an anti-leakage effect but in fact it will have an anti-participation effect. People will avoid saving here if they are not able to make withdrawals when desired. If the decision is made to NOT limit distributions, then one of the following options must be chosen.

Path Two – Catch Up Distributions. After the end of the year actual results are posted and the board would decide on adjustments with the reserve - in years where the board decides to enhance returns – the recordkeeper would be required to go back and adjust all plan distributions from the prior year with a second distribution. This doubles the distribution costs, straddles tax reporting over two years, potentially calls for a bifurcated payment if the participant status changes ,etc… it's a difficult recordkeeping strategy.

Path Three – Fixed Policy for mid-year distributions. Adopt a policy that provides a formula for determining investment outcomes for mid-year distributions. As the recordkeeper is processing distributions throughout the year, if a participant requesting a distribution is facing a realized loss for this year, the recordkeeper would true it up to zero and bill the reserve account. That might have the recordkeeper drawing on the reserve account even in years where the fund is up for the calendar or investment year. Viewed at its worst, participants who stay could be funding participants who go. This would be true anytime there was a down point during a year and participants exited without experiencing their losses.

Path Four – Mid Year distributions are excluded from reserve participation. This approach has a hidden problem. Imagine if you would that it's the tenth month of the "reserve year" and participants can clearly see that the fund has had a very good year. Somewhere in the marketplace will arise a "CSC Alert" social brand.   That "Alert" might issue a "Sell" if the fund is up – attempting to inspire account holders to withdraw their funds before the reserve determination is made and actual gains are potentially reduced. The call center will get flooded with redemption requests.

Path Five – A hybrid or combination of approaches.

Any of the paths chosen will cause a multiplication of the costs for benefits processing, an increased cost exposure to the guarantor or guaranty process, an increased cost for participant education or support, and or the potential for a lot of bad press.

I attended public hearings and it became quite clear in testimony and private casual conversation that there is a tremendous risk that the Pooled Fund with Reserve will be misunderstood. The range of misunderstandings I experienced included the following;

> The fund can't lose money,
>
> That it has a guaranteed return rather than downside protection,
>
> Very little understanding that in good years gains could be peeled off for later years,

And at the very worst just one person who was under the impression the account would self-fund – that they would agree to the account and it would be funded for them.

Those are just the four perceptions that I heard. The anti-disinformation campaign required on a choice like that is going to be expensive and difficult. If it isn't properly engaged, the call center will bear the burden – and likely fail. No one withdraws their savings faster than a person who just realized they may not have understood what they were putting their money into.

Pooled Funds with Gain/Loss Reserves have a long history of success in plans with the artificial behavioral constraints of plan rules, product and trust policies. It is typically understood in those voluntary and often employer funded plans – that account balances are not immediately liquid. In the very different environment of individual IRA's that arrangement will pose significant risk to the overall program. At the very least – unattractive policies meant to make the pooled/reserve arrangement functional – will make the program unattractive and drive down utilization.

If the "pooled fund with reserve" option is chosen, the projected utilization is dramatically overstated and resulting program costs are dramatically understated in my opinion. This type of program will not capture 50% of the initial launch wave while the market is providing much more attractive options.

Employer Responsibilities and Risks are Limited in Private Sector Solutions.

In today's Fiduciary care models – the role of the employer is limited to the following;

Provide accurate and timely employee data.

Provide accurate and timely contribution data.

Remit contributions in an accurate and timely fashion and form. (Usually electronic).

If the employer is using a payroll service or software for the most part they will be able to opt into payroll integration that does not require them to provide any of that data in a manual fashion. It should be noted that companies with over 100 employees very rarely do payroll without a system or service. Those companies will already have robust solutions available to them from familiar brands that they will likely engage in the presence of a mandate.

The employer is decoupled from the employee with today's available retirement services. Employees/participants are connected directly to the platform savings provider/recordkeeper and or a rep in the field. That connection happens via text, app, email, call center or chat. There is also a rapidly expanding list of Employee Self Service portals where employees can go for their health, tax and benefit forms and information – all directed to the micro and small market.

Micro and small employers can outsource the responsibility for ensuring their participants' retirement goals are properly set and that participant actions are documented and directed to meet those goals.

Bottom line is that the CSC will not enjoy an advantage in reduced employer or employee risk management nor enhanced customer experience.

Facilitate Success for Now – Educate For Success Later

I want to caution the readers of the paper to not make the mistake of treating this population of target savers too differently than the rest of the saver's worldwide both inside and outside of save at work plans.

The workplace savings industry was initially served directly by the manufacturers of investment products – so retirement work looked like investment work or products. The bulk of workers don't want to be burdened with the need to know the ins and outs of investing and investment choices so the immense quantity of information in those solutions was a deterrent for them.

This isn't unique to savings opportunities. The bulk of car buyers don't want to know whether the car they are purchasing has electronic or mechanical fuel injection or whether the tires are filled with nitrogen (good idea) or oxygen. They just want to know that they turn the key and drive it. Soon, they will want the *car* to know that its time to warm up and drive them to work. Employers and workplace savers want the same thing from their retirement plan – and the retirement industry has produced solutions.

Education will need to be focused not on the spectrum of investing but on how to think about long term vs. short term savings and help the user self-identify the appropriate course for them.

I can say with near certainty that every leading market solution available today is designed to engage the active saving enthusiast while also providing a sensible default path for savers who do not engage with the tools, calculators and other solutions available to them. The need to work successfully with unengaged savers and non-savers is already baked into market offerings from the private sector.

The “F” Word

There is a lot of energy being spent these days on the issue of Fiduciary liability and Fiduciary services. The market is successfully closing that gap.

Traditionally “Fiduciary” was described as a fog that covered the industry, the providers, distributors, plan sponsors and savers in a mist. A mist from which at any moment some unknown force could reach out and introduce mayhem. The industry has followed some familiar approaches –

> Be involved in everything and charge for it.
>
> Be sure that everyone understands your brand is “not it”.
>
> Big Data – used well or not well.

In fact, the market has come to realize that "Fiduciary" is a data driven issue – small data – not big data. Each and every day a participant's journey to retirement readiness does one of three things – gets better, gets worse or remains neutral.

> Some things are obvious. If a participant reduces their contribution, invests in too much or too little risk – retirement readiness is negatively impacted.
>
> Some things are not so obvious. A pay raise resets the bar for retirement readiness. A retirement raise should accompany the pay raise.

Systemic Fiduciary issues such as choosing investments at arm's length and cost management are pretty well wired into the market today. Stated simply – it's pretty easy to stay out of trouble on those issues if you choose to do so.

The market has a number of Fiduciary service models available today – from investment centric designed to keep the investment choices in line with plan rules/policies all the way to participant outcome centric designed to guide, promote document and reward behaviors.

To the extent that the Program is to be differentiated by its Fiduciary protection – it will not be. The market already has many flavors and many prices to cover that.

Best Practices – Investment Policies and Options.

In order for the Program to capture market share it needs to be in step with what the market has to offer. The state of the art these days is for a plan to have a selection of managed portfolios aligned with varying levels of target risk. Employees are defaulted - according to policies set by the investment fiduciary – into the portfolio that most suits their position on the journey to and through retirement. The participant is notified and allowed to adjust to a different portfolio as they choose. In today's marketplace there are organizations that sell the service of matching the saver to the portfolio. In the past, investment choices were made available and participants were required – without regard to their knowledge or comfort level – to make a choice or choices from among the funds offered. Today, the participant can be appropriately placed in the portfolio by a fiduciary service. This approach facilitates success for the unengaged while allowing choice for the actively engaged – all the while protecting the employer from liability for participant choices.

The market has evolved to a higher standard of care. Care should be taken to make decisions in 2016 that are not based on 2011 market offerings.

The employer who has a population of employees with the exact same level of investment expertise and interest doesn't exist. Forcing all employees into a plan with no choice and no guidance invariably underserves some portion of those employees. Much better that we use readily available solutions in the marketplace to *install the financial expertise as a feature of the program*.

Investing a 25 year old like a 65 year old does that 25 year old the disservice of opportunity cost. Investing a 65 year old like a 25 year old introduces tremendous risk of significant, negative, unrecoverable outcomes for the 65 year old. Investing the 25 year olds and the 65 year olds like a 45 year old is a fine compromise – but with today's technology and available services it isn't required – so why do it? It will make the program noncompetitive, add risk, complicate communication and drive down utilization.

The main danger for savers is committing money needed for short term issues or contingencies to the risk of the marketplace. There are a number of ways to address that risk in the program design while still allowing individual active choice. An example would be to direct initial contributions into a stable value fund until the balance hits a prescribed value and then open up market opportunities.

In addition to the concerns above there is a scenario that will be common and on its best day will result in employers choosing a market solution. Many business owners who are subject to the mandate will also not qualify for a Roth IRA due to income exclusions. As a result, they may set up the state plan for their employees and get a separate IRA for themselves. Anytime an employer creates separate benefit solutions for themselves vs. their employees it introduces the risk of someone taking issue with the fees, outcomes or features of the two solutions.

Innovations and Opportunities

The following are some innovations and opportunities to consider for program rollout and legislative efforts.

Short term vs. Long Term investments. New savers have a higher level of concern for investment losses in early years. I am in favor of a design that places participant money in a money market or stable value type of fund during the first 90 days of contributions – until they no longer have the option to "reverse their contributions". Beyond that the market has seen its best results matching the participant to the portfolio using a service that does so.

Interoperability – The Board needs to be given the latitude to let the recordkeeper "push" customer information where they authorize it and where they will make the best decisions for themselves. Customers should be allowed to have their account information available in their bank site, tax site, personal bookkeeping package, employee HR site, etc…

Rewards and Gamification – The Board needs to be given the latitude to introduce behavioral rewards into the program. California has a tremendous opportunity to move "saving" forward with an overt strategy on this topic.

Social Security – item one for most workers' retirement is Social Security. It would be very helpful if California took an active voice in requesting the Social Security Administration to allow participants to authorize the SSA to transmit their data to their specifically authorized savings tools. Many conversations would be shortened by having the actual data available in the support conversations. It reduces expenses.

Automatic Re-Enrollment – I do not believe the report dealt overtly with the topic of re-enrollment. I strongly suggest that the Program be allowed to re-enroll participants who opt out at some interval – say every three years. Two would be better.

Automatic Escalation – the industry has moved beyond the "1% on January 1" model. The Board should be empowered to allow other forms of escalation – birthday notices ("Happy Birthday – give your future self a year off - $24.70 per paycheck – click here"), work anniversaries, pay raises, reward systems, etc…

Intermediaries at the employer and employee level – The communication and operational costs of the program will be significantly reduced if the recordkeeper is allowed to formalize the role of intermediary at the employer and employee level. The intermediary is someone who could be allowed to view accounts, receive automated updates – and with proper controls – provide data or a very limited instruction set.

Participant communication. The Board should be allowed to engage best practices with participant education. Participants should be provided with opportunities to "acquire retirement" rather than "defer pay". When a participant takes a distribution from their account, the recordkeeper should be allowed to present that withdrawal in terms of how much retirement it represents. "Dear Participant, A withdrawal of $X,XXX now will reduce your projected retirement funding by X years. Let us help you find alternatives to protect your retirement."

Recommendation

The mandate is something that I disagree with personally, however professionally there is no denying that it will close a gap that needs to be closed. As a business owner I am troubled by that fact, however as a business owner I prefer to head off problems when I can. The mandate proposed by California is a necessary first step to head off a large portion of a problem that faces the entire economy – not just the retirement industry. Where the industry was ten years ago or even five years ago – I would have spoken against the mandate in loud and clear terms. Given that the industry has evolved to an outsourcing solution for the small and micro market that adds value to its customers at prices that meet the expectations of most state initiatives – the mandate will be effective without being harmful.

The fastest, lowest cost, lowest risk path to getting the goals of this legislation covered is a mandate with a marketplace. Best practices in evaluating providers can be built in and the market bears the much reduced cost of outreach and implementation where a mandate exists.

To the extent that a state solution is deemed necessary or desirable;

Keep the legislation as loose and market responsive as possible. There are clear gaps between what the market was five years ago and what it is today. The Board should be empowered and charged with the decisions necessary to keep the program up to date and successful. Contributions, investments, education and decumulation strategies should, as much as possible be left in the hands of the Board. The pace of innovation must be supported.

Investment Choice – The business goal is met with a single fund solution of a stable value or conservative nature. It will serve its goals and cost of implementation will be low. A best in class solution is an option that will require considerably more money and time to reach the coverage goals of the legislation.

If the CSC is geared to a one fund choice solution whether it is market based or stable value– the offering is not going to compete well with market offerings that include options, individual selection – and most importantly – built in fiduciary support at the employer and participant outcome level.

If the CSC is designed to align with a known definition of success – it will meet the goals and needs of the community it serves – and set an example for the remainder of the country that is paying such close attention to this breakthrough effort.