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Delivering Vision and Value to the Financial Services Industry

POINT of View

State IRAs Provide Opportunities for Financial Services Organizations

BridgePoint's Update on State-Mandated IRAs *by Barbara March, CEO*

According to the National Institute on Retirement Security, 45% of working age households (38 million adults) do not have retirement assets.[i] Nearly half of private sector employees currently lack access to an employer-sponsored retirement savings plan, and while many independent savings vehicles exist within the consumer marketplace, they do not carry the convenience of payroll deduction and the benefit of automatic enrollment. Further, employees that are not eligible to participate in an employer program don't receive the same education and regular messages to encourage retirement savings. Emerging state-mandated IRA programs have the potential to provide an improved solution for these individuals, and these programs could also present an attractive business opportunity for both services providers and asset managers.

Of the 27 states that have either commissioned studies to assess the viability of a program, proposed legislation to implement a state-mandated IRA program, or have passed legislation, 74% did so just last year. The initial states will be seeking proposals as early as this year from the financial services industry to provide products and services to facilitate their programs, with Illinois' Request for Proposal (RFP) expected imminently. This document, informed by our work with the various states and interested providers, provides a perspective on the pros and cons of these programs for consideration among industry services providers.

For the first time in recent history, there is a significant opportunity for providers to capture net new assets from additional entrants to the retirement market. In California alone, when fully enabled, the program is projected to inject between \$6 and \$8 billion per year of new assets.[ii] Providers are also viewing participation in state-mandated IRA programs as a way to support broader business growth strategies.

The opportunity does not come without its challenges, however. Experts anticipate these IRA accounts will have an average contribution in the range of \$1200 per person, per year. The resulting small balances, coupled with a high volume of employers, will present significant administrative challenges.

States will want to keep costs extremely low while minimizing the burden on small employers, and they do not necessarily appreciate and understand the magnitude of the administration or relative attractiveness of this business to financial services providers.

BridgePoint is engaged to facilitate the translation of state needs to provider capabilities. Collectively, as financial services industry professionals, our opportunity is to align our tremendous experience servicing millions of retirement shareholders to these state program strategies and implementation plans in order to support a viable market solution.

California's Secure Choice Program: A Potential Model for Other States Moving Forward

BridgePoint was engaged as a subcontractor to provide expert advice on the operating model for California's Secure Choice state IRA program. Given the state's desire to minimize annualized program cost for both investment management and recordkeeping, we were asked to provide a feasibility study to the California Secure Choice Retirement Savings Investment Board of Directors for both the customer experience and operating model. Our goal was to educate the Board on the trade-offs, the services available in the industry, and the challenges associated with a high-volume, low-cost model. The core objective was to determine how to best reconcile the critical factors of scale, cost, and customer experience. The State of California's goal was to not exceed an all-in cost of 100 bps for the program while achieving a minimum viable offer that would deliver the best possible customer experience and investment options.

Overture Financial, the lead consultant for the State of California, produced its final recommendations to the Board on January 31, 2016. The full report is available at http://www.treasurer.ca.gov/scib/report.pdf.

In order to provide financial services organizations a strategic lens with which to view state-mandated IRA opportunities and to anticipate what will be included in possible RFPs, BridgePoint is offering brief insights into California's proposed program design. This includes information on potential adoption rates, program design, and a proposed operating model.

Key points of the State of California program include:

Anticipated High Participation Rates and Lower Turnover Rates
The mission of California's Secure Choice program is to establish an auto-enrolled, state-run retirement plan for California's 7.5 million employees who are not currently covered by employer-sponsored plans. Participation rates are anticipated to be between 70-90%.

Recommended Program Design Elements
An eligible employee under the California Secure Choice program is defined as a worker who is covered by California unemployment compensation and is presently residing in the state. (It is important to note that employers may go in and out of mandate as their number of employees fluctuates. If they go out, they can opt to continue to send contributions for existing employees, but they cannot auto-enroll new employees.) The default contribution rate is currently proposed at 5%, with a 1% auto-escalation rate up to 10% (provided the selected recordkeeper is capable of administering the feature). Employees who choose an amount other than the default could still opt in to auto-escalation.

Roth IRA Default Option: The final report recommends that the Roth IRA will be the default option for employees, but they will be provided with the option to select a Traditional IRA instead. There is a 6-month safe harbor for employees who change their mind with respect to contributions. If they decide to opt out, they must be able to obtain a refund of their current balance absent of fees.

Single Recordkeeper: The recommendation is for a direct service model with a single recordkeeper, without the state's Employment Development Department (EDD) functioning as intermediary.

Custom Target Date Funds: Overture recommends utilization of a custom target date option rather than using an existing target date fund from a single provider. This means that the state program would essentially have a series of target date portfolios comprised of funds from multiple assets managers, likely with a single overlay manager. Our insights into other state programs indicate a willingness to leverage existing target date funds without the customized option.

Hardship Requirements for Early Withdrawal and Default Payout Option: Currently, the recommendation to restrict withdrawals to self-certified hardships and set a default payout of lifetime income does not conform to the DOL's proposed fiduciary regulations. The state will need to obtain an exemption or modification to the rule from the DOL in order to move forward as planned, or simply conform the program to the DOL regulations as proposed.

Supplementary Operational and Demographic Requirements

The recordkeeper for California's Secure Choice Program will need to:

- Receive account set-up and funding information directly from employers (over 300,000) and/or their payroll providers
- Track Traditional IRA elections for those who opt out of the Roth IRA default
- Provide a facility for employees to opt out of default contribution rates (either for zero contributions or a percentage other than the default rate) and auto-escalation changes while ensuring that this information is fed to the employer and/or the employer's payroll provider
- Be able to receive employee contributions from different employers over time and perhaps even simultaneously if an employee holds positions at two or more employers
- Escheat monies to the state if IRA account holders can no longer be found since there is currently no provision to be able to cash out small, inactive accounts

Considerations for Financial Institutions Interested in the State IRA Market

The potential for financial institutions to capture new retirement assets is unprecedented and offers an opportunity that should be taken seriously, as more and more states consider auto-enrollment plans for non-covered employees. At least five states have passed legislation allowing a mandatory payroll deduction IRA program already, with Illinois and California being seen as leaders. Both Oregon and Connecticut are also moving forward rapidly.

Further, as it currently stands, mandatory payroll deduction IRA programs are not qualified plans and are not subject to ERISA. Neither the state nor the employer will be considered plan sponsors for purposes of ERISA. Consequently, this relieves a portion of the fiduciary burden and makes these plans more attractive to both employers and the states. However, it also means that both employers and the states will play a limited role in the programs, and the recordkeeper will assume responsibilities of maintaining a large number of IRAs while also providing some small DC plan-like services.

Support Will Entail a Hybrid of Retail and Institutional Capabilities
When matching the potential design of these programs with the capabilities of many financial services providers, it is evident that these models require a blending of retail IRA construction with the services traditionally offered through institutional qualified-plan administration. These hybrid models will likely require new capabilities or partnerships to fully provide the needed services with both efficiency and scale.

Program Design Implications from BridgePoint's Perspective

Scale will indeed be the primary issue for both asset managers and recordkeepers looking to support state-mandated IRA programs.

From an asset management perspective, there is a potential that these plans will require open architecture in which no single asset manager is awarded all investments. With Overture's recommendation for the State of California's Secure Choice Program, for example, there will be a need for an overlay manager to establish the guide path. The recordkeeper will need to be able to operate in an open-architecture environment and may or may not be awarded any or all of the investment management.

We believe there is also an opportunity for a smaller provider to leverage technology, either proprietary or through a partnership with a third-party provider, to get to scale in order to handle the influx of new participants and the volume of payroll deduction contributions from the thousands of individual employers and their payroll companies.

Additionally, there is room for a provider to expand its retail business through marketing to the millions of potential new participants or members of their households. It is important to consider that the participating employee may be a part of a household that may be more or less attractive as a retail customer.

Operating Model Considerations for Recordkeepers
Due to the complexity of requirements and operating cost constraints, recordkeepers will need to have capabilities to adapt to the sheer number of employees and employers/payroll providers. This will have to be accomplished through internal development, acquisitions and/or partnerships.

On average, 70% of provider operating budgets represent employee compensation; therefore, it is critical that the operating model be designed to support the program in a manner that allows for human resources to focus only on the highest-value activities.

There are four core operating model tenets that BridgePoint recommends for recordkeepers entering the state-mandated IRA space. Those tenets are to minimize variation, reduce the sources of data, provide a clear and intentional customer experience, and implement a robust, integrated technology platform. Managing as many as possible of the required activities at the source, without placing undue burden on participating employers, will ensure that program resources support only those activities critical to the success and scalability of the program.

By minimizing variability, complexities will be diminished, and it will be possible to get to a viable offer – especially when considering the cost constraints imposed by the states.

Similarly, we recommend limiting the number of data points to those which are critical to the enablement and consumption of program-related services while keeping the data transfer model and supporting connection points as simple as possible between the employers, the employees, and the state. Facilitating data collection, validation and transfer through the web, with supporting automatic transfer protocols or self-service capabilities where possible, is the preferred approach.

With respect to customer experience, BridgePoint recommends a simplified model to promote cost efficiency due to the large number of participants and employers. Limited interactions between the employer and the recordkeeper are critical, and most participant communications should be administered through digital delivery channels.

Technology requirements include strong integration and straight-thru processing, with solid front-end user interfaces.

Broader Potential for Providers

Many providers across the industry are challenged with limited growth through traditional channels and are actively seeking new sources of revenue. While the state IRA opportunity may not appear to be singularly attractive, providers should examine the potential this business may provide to inform or leverage broader business strategies.

Separately, many providers are still striving for scale within the qualified plan and IRA arenas. Costs to serve remain high; however, by designing and deploying a low-cost, high-value operating model required to support state IRA programs, firms may identify a path to lower the overall cost of infrastructure and delivery across alternate product lines.

In conclusion, the desire to improve the nation's retirement coverage and savings challenge remains an admirable endeavor, and we believe it is an achievable goal. BridgePoint's role is to leverage our collective industry expertise and guide the exploration of solutions for providers and asset managers in support of these programs. We believe there is a substantial potential for broader business benefits and anticipate there will be firms willing to engage in this market opportunity.

For more information on how BridgePoint can support your organization, please contact:
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[i] National Institute on Retirement Security, "The Retirement Savings Crisis: Is it Worse Than We Think?", 2015.

[ii] Overture Financial, LLC., "Final Report to the California Secure Choice Retirement Savings Investment Board," January 31, 2016.