To: Connecticut's Retirement Security Board

From: Teresa Ghilarducci, The New School for Social Research

Date: November 24, 2014

Regarding: RFI on Public Act 14-217

The CRSB's market feasibility study will examine the goals and design features of a state sponsored retirement plan that aims to provide Retirement Security for all Connecticut workers by helping them save for their own retirement safely and securely.

The Public Act 14-217 was passed to address the looming retirement crisis in Connecticut caused primarily because almost half of the workforce in the state do not participate in a retirement savings plan at their workplace.

I am the director of The New School for Social Research's Center for Economic Policy Analysis in the Economics Department. We calculated that middle-class families in Connecticut are at risk of becoming poor and near - poor retirees; almost 50 percent of middle-income Connecticut workers will retire at or near the poverty line because they do not have retirement savings over and above Social Security.

I, Professor Teresa Ghilarducci, Chair of the Economics Department and Director of the Schwartz Center for Economic Policy Analysis Schwartz Center for Economic Policy Analysis, New School for Social Research (6 E. 16th St. New York, NY 10003, Phone: 212-229-5901 # 2) submit these answers to the RFI for the Connecticut Retirement Security Board.

Executive Summary

The Connecticut Retirement Security Board new plan – let us call it "Connecticut Retirement Accounts" could provide for competition between for-profit private money managers and a public sector option managed by the State Treasurer or under contract with the Public Employees' Retirement System.

We are providing a description of how the program managed by the State Treasurer or the State Pension Fund would work because the Request for Proposals (RFP) asks for all the relevant issues to be considered in selecting vendors. We are also especially concerned about how the private vendors will be registered.

The Connecticut Retirement Plan could establish a Clearinghouse that will display registered private-sector vendors who market employer-sponsored retirement plans and payroll deduction IRAs for employers who wish to use such vehicles. These private sector, for-profit, vendors would include information that would enable employers to compare listed plans or payroll-deduction IRAs with each other and with the CRA.

The system should require every employer to offer the CRA as an employee choice. Moreover, all employees should be auto enrolled in the CRA with an option to opt out and redirect their money to be managed by a private vendor in the Clearinghouse. Employees decide whether they stay with the CRA or whether they choose an alternative private vendor offered plan. Employers are therefore relieved of their duty to make these choices. (As a result, employers no longer bear much fiduciary burden related to offering retirement savings choices for their workers.)

The Retirement Clearinghouse allows private vendors to compete with the CRA and requires the vendors to disclosure specified information. But participants need accessible and easily understood information - the disclosure requirements need more client protection -- and more importantly, concrete protection from the private vendors than the Clearinghouse now requires.

The legislation should require that plan features be listed in a separate category so people can easily see one choice over another provided protective features. This is one example of a better kind of disclosure and helps protect participants, but the statute can be improved in this area. Based on experience in the US, UK, and Chile, we believe it is imperative that the registration certification for private vendors on the Clearinghouse not only require extensive information disclosure but provide minimum protective standards, even if this requires revisiting the legislation. Private vendors listed on the Clearinghouse should be required to cap fees and provide near guaranteed options like TIAA -CREF and the CRA do. Recent regulations in UK is state of the art fee disclosure. Without these safeguards, registered vendors will reproduce the model of poorly-performing IRA and 401(k) fund private plans.

Plan Structure:

We recommend that a not-for-profit quasi-government agency provides a retirement account for Connecticut workers -- the Connecticut Retirement Account (CRA) - and that it have the following administrative structure.

Simplicity and ease of administration

The Connecticut Retirement Account (CRA) is an individual IRA managed safely and securely by the Board of Administration of the Public Employees' Retirement System or by the State Treasurer). These accounts provide benefits based solely on the employee's contributions and returns (no contribution from the state). They have all the protections similar to ERISA.

Only workers contribute - employers would contribute indirectly by boosting workers' pay to compensate for some or all of the contribution.

At least 3 percent of pay (a consistent 3% contribution over a career is the bare minimum for adequate retirement income with Social Security) would be directed to an individual CRA and contributions would be channeled through the already-existing payroll deduction system. The board could reduce this to 2% of pay or increase it to 5% of pay.

Every employer would be required to offer the CRA, and all employees would be auto-enrolled in the CRA. Employees could select an alternative private vendor from a menu of providers listed in the Clearinghouse. The employer has to offer the CRA if it does not have any other type of ERISA plan. We believe that every worker deserves a supplemental annuity plan and that every worker should be auto enrolled in the CRA .

Portability of benefits

Individual CRA s are portable; the accounts would automatically move with a worker from job to job, unlike 401(k)s, which are tied to a particular job and difficult to roll over.

For CRAs to be truly portable, all employers in the state (except for very small employers) would be required to offer the CRA . Employers would still be able to offer a DB or 401(k)-type plan in addition. If employers choose to offer both the CRA and a 401(k), their employees could indirectly contribute to their CRA, or directly to their employer's 401(k), or both.

Preservation of principal

Contributions invested in a CRA would be guaranteed to earn a return determined each year by the Connecticut Retirement Savings Investment Board. The guarantee ensures that individuals' retirement accounts are protected from the volatility of the stock market.

Simulations by New School Ph.D. David Stubbs show that returns of a balanced portfolio earned a return of at least 3 percent adjusted for inflation for the last 75 years, 100% of the time, for all years .

Public policy should allocate risk to the entity that can more efficiently and cheaply insure against it; this policy shifts risks away from individual workers, who cannot predict their age of retirement (they bear cohort risk,) to all workers at different ages.

The state does not absorb the risk, the participants in the CRA, as a group, do.

At retirement, workers would convert all or part of their CRA balance into an annuity-a guaranteed stream of income for life-to ensure that they do not outlive their savings. These features of the CRA are possible because individual account assets are invested together in large pools, with an emphasis on low-risk, long-term gains. Pooling takes advantage of economies of scale and minimizes financial risks. There could be gradual annuitization over time, so that timing of annuity start dates does not put participants at interest rate risk and also so participants are able to pool mortality risk beginning at earlier ages.

Investment options

The Connecticut Retirement Investment Board would contract out the fund's investment and management to the State Treasurer, or to the Board of Administration of the Public Employees' Retirement System. Assets in CRA s would be invested in one large pool. Pooling assets has a number of significant advantages, including low fees, reduced risk and higher return because they can have a long term time horizon. That the CRA s can be invested in liquid and non liquid assets is a large advantage sometimes overlooked by policy makers. IRAs and 401(k) plans force people to put their long term savings into all liquid mutual funds. This means workers are paying liquidity premiums for liquidity they don't need. The CRA s pooled investment approach saves employees this unnecessary premium.

These points are discussed below.

Professional Investment Management: in the 401(k) system, investment decisions are made by employers and individuals. Pooling individual assets allows investment decisions to be made, instead, by professional investment managers, who consistently outperform individual investors.

Longer-term Investment Horizon: To minimize market risk, 401(k) investors have to shift towards increasingly conservative portfolios as they age, often at the expense of higher potential returns. This tradeoff is costly because it reduces returns the most at a time when workers' assets are at their peak: when they're nearing retirement. In contrast, when assets are invested as a pool, there is no need for such a tradeoff. Because new workers are constantly entering the pool as older workers retire, the fund's investment managers can maximize returns over the long-term, not just over an individual worker's lifetime. Of course, this comes at a cost, since people will not fully share in the upside of the market, since the guaranteed interest rate will be reduced in periods of strong market performance to create reserves.

Lower Fees: By taking advantage of economies of scale, pooling reduces both investment management and administrative costs.

4. At retirement, workers have the option of either converting their entire account balance to an inflation-indexed annuity or receiving a partial lump sum, limited to 10 percent of their balance. These annuities would also provide survivor benefits unless the worker opted out in exchange for a higher single-life annuity. The Connecticut Retirement Savings Investment Board will choose private-sector annuity providers based on a competitive bidding process; the Board of Administration of the Public Employees' Retirement System (s) could also provide the annuities. The form of the annuity will be structured so that the state cannot be at risk.

5. The newly created Connecticut Retirement Savings Investment Board (the Board) would oversee the plans' operations. This Board would assume all fiduciary, or legal, responsibility for the fund's investment decisions and administration. Fiduciary duty requires all decisions be made entirely for the sole interest of the savers- not the share-holders of the financial service industry- which is a higher standard than the professional standards currently required of 401(k) providers.

The Board would delegate investment management of the CRA to the State Treasurer or to the Board of Administration of the Public Employees' Retirement System (s) which would bid out actual investment of the funds to private sector investment companies. They would likely contract out the fund's recordkeeping and participant communications to third parties.

Legislation would specify guidelines for fund investment, participation, vesting, and benefit accrual. These guidelines would include principles and restrictions concerning how funds are managed and invested, limits on administrative expenses, the length and timing of enrollment periods, employer and employee contribution limits, and payout options, among other details.

Plan design and feature

8. The Connecticut Retirement Board would set the default contribution rate between 3-10 percent of a worker's salary depending on current market performance and economic conditions. In other words, the contribution rate would not necessarily be 3%; the Board can act to change the rate.

10. As in 401(k)-type plans, contributions are made pre-tax and returns accumulate tax-free. Tax-deductible contributions to a CRA would have the same limit as a 401(k): $17,000 as of 2012. However, this would be a shared limit: individuals could contribute up to $17,000 between their CRA and/or their 401(k). Employers would be able to add to a workers' salary to cover their contribution to a worker's CRA , but they would not be required to contribute. Like other contributions to pension plans, employer contributions to the CRA would be tax deductible.

If the participant moves to another state, the CRA would stay open and continue accumulating returns, but the worker could no longer contribute through their new (out-of-state) employer.

But this feature should be changed using all technology available so that workers can consolidate their accounts as easily as possible. An online system that allows accountholders to contribute outside of the workplace would make it possible for workers to continue contributions to their CRA if they moved out of the state or were temporarily unemployed or out of the labor force.

Participants would begin collecting retirement benefits at the same time as Social Security, and therefore no earlier than the Social Security Early Retirement Age, i.e. age 62.

Workers with a 401(k)-type plan or IRA could roll over their balances into their CRA . However, following the same reasoning for prohibiting early withdrawals, transferring CRA funds into 401(k)-type accounts would be prohibited. Rollovers would be administratively expensive and would defeat the goal of connecting workers' long term savings to longer-term assets-a necessary condition for guaranteeing secure and adequate returns. The statute and Board should permit rollovers from other plans or IRAs to CRA .

Account balances of participants who die before retirement will be transferred to the CRA of their designated beneficiaries. Those who die after retirement can leave their remaining CRA assets to their heirs either as a lump sum or as a (larger) transfer to their CRA or as a beneficiary on the annuity.

11. CRA funds are accessible only at retirement. Funds cannot be accessed before retirement for any reason other than death or disability. Eliminating early withdrawals reduces the fund's liquidity requirements, allowing CRA s to offer the highest guaranteed rate of return at the lowest possible cost. Limiting or prohibiting early withdrawals also helps ensure adequate retirement income. The CRA is meant to be an adequate supplement to Social Security, one that workers can count on at retirement.

Costs and fees

12. There are, of course, costs associated with running any kind of retirement plan. These costs can be grouped into three major categories:

a. Administrative costs for bookkeeping and informing participants of account balances and plan features

b. Investment management costs for investing participants' savings

c. Marketing costs for media advertising of the plan's virtues.

13. Participants in any retirement account pay all or the vast majority of administrative costs through fees charged as a percentage of their account balance and paid out of their investment returns. Participants in a CRA would pay its costs in exactly the same way: out of the returns earned by their savings, before their accounts are credited with those returns.

The current provision in SB 1234 that allows for private vendors to register with a Retirement Investments Clearinghouse needs to include a cap indicating the maximum allowed fees that may be assessed on individual accounts, notwithstanding account holders' choices with respect to the investment choices they make. This would ensure that employees pay similar fees whether they choose to have their money invested by the State Treasurer or Board of Administration of the Public Employees' Retirement System or by private money managers.

Legal issues

18. The Employee Retirement Income Security Act of 1974 (ERISA) regulates all private workplace retirement plans. ERISA is a federal law enforced by the Department of Labor (DOL) that requires employer-sponsored retirement plans to meet certain minimum standards regarding participation, vesting, benefit accrual and funding. ERISA also holds plan fiduciaries accountable and requires plans to regularly provide participants with plan information. The CRA uses an employer payroll tax system to direct funds and, therefore, is not an ERISA plan. Since employers offer the CRA , along with the for-profit registered vendors, the employer is not choosing a plan for the workers. But, to protect participants, all registered vendors should meet ERISA - like standards and standards that exceed ERISA standards.

19. Legislation would be needed to specify guidelines for fund investment, participation, vesting, and benefit accrual. These guidelines would include principles and restrictions concerning how funds are managed and invested, limits on administrative expenses, the length and timing of enrollment periods, employer and employee contribution limits, and payout options, among other details.

Private insurance contracts would back all assets in the fund. In the unlikely event that there are any shortfalls, private insurers would make up the difference. The insurance premiums would be paid out of CRA participants' returns. The cost to insure the plan would be low, since the risk that the fund would fall short of its promised returns would be minimal (see below for a discussion of the fund's minimal investment risk). Neither the state nor the employer would be held liable or bear any fiduciary responsibility for the fund. We would like to see this as a mandatory feature of the plan.