Financial Feasibility Analysis

Presentation to the Illinois Secure Choice Board

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Background on CRR

- CRR has engaged with Connecticut, Washington, Oregon, New York State, and New Hampshire on their retirement savings initiatives.

- In Oregon, CRR created a financial feasibility model.
  - The Oregon model predicted its program would be profitable for a provider within a decade.
  - Providers have indicated they agreed with the assessment, and the RFP process bore it out.

Outline of today's presentation

- Introduction
- When will program's annual revenue cover operating costs?
- When will program pay back its initial costs and losses?
- How can financial feasibility be improved?

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The feasibility of Illinois Secure Choice (ISC) depends on achieving two outcomes.

1. The program must ultimately become cash-flow positive, generating enough revenue to cover ongoing administrative and per-account operating costs.

2. The program must become net positive – able to repay losses that occur at startup (both from fixed implementation costs and operating losses) – within 10 years, the maximum amount of time allowed for a contract.

To model these outcomes, CRR started with initial inputs and tested variations.

Parameter	Initial assumption	Alternatives
Employees affected	Those with no plan at work and at employers with 25+ employees, 2+ years existence	Can be tested upon request
Program rollout by employer size	Year 1: 100+ Year 2: 50+ Year 3: Remaining	Can be tested upon request
Contribution rate	3% fixed	5% fixed 3% escalating to 6% over three years
Participation	75-80%	Can be tested upon request
Startup costs	$1m fixed $200 per employer	Can be tested upon request
Annual ongoing costs	$1.0 million administrative $30 per account 10 basis points investment	Can be tested upon request
All-in fee on assets	75 basis points	100 basis points 75 basis points, $1 monthly fee on actives

Results suggest that ISC will take over 10 years to become net positive.

- Given the initial assumptions, the program is estimated to:
  - Become cash-flow positive in 10 years; and
  - Become net positive in 18 years.

- Over this initial period, the highest cumulative deficit of the program – a measure of risk for providers – is $123.9 million.

- The length of time to become net positive can be shortened considerably with changes to default contribution rate or fees.

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Operating costs are mostly fixed per account, while revenues depend on fees from assets.

Operating costs

Recordkeeper's cost
$30

x

accounts
Year 15: 1.2 million

Annual account administration cost
$1.0 million

Investment cost as share of assets
10 basis points

Startup costs

One-time fixed cost to ISC

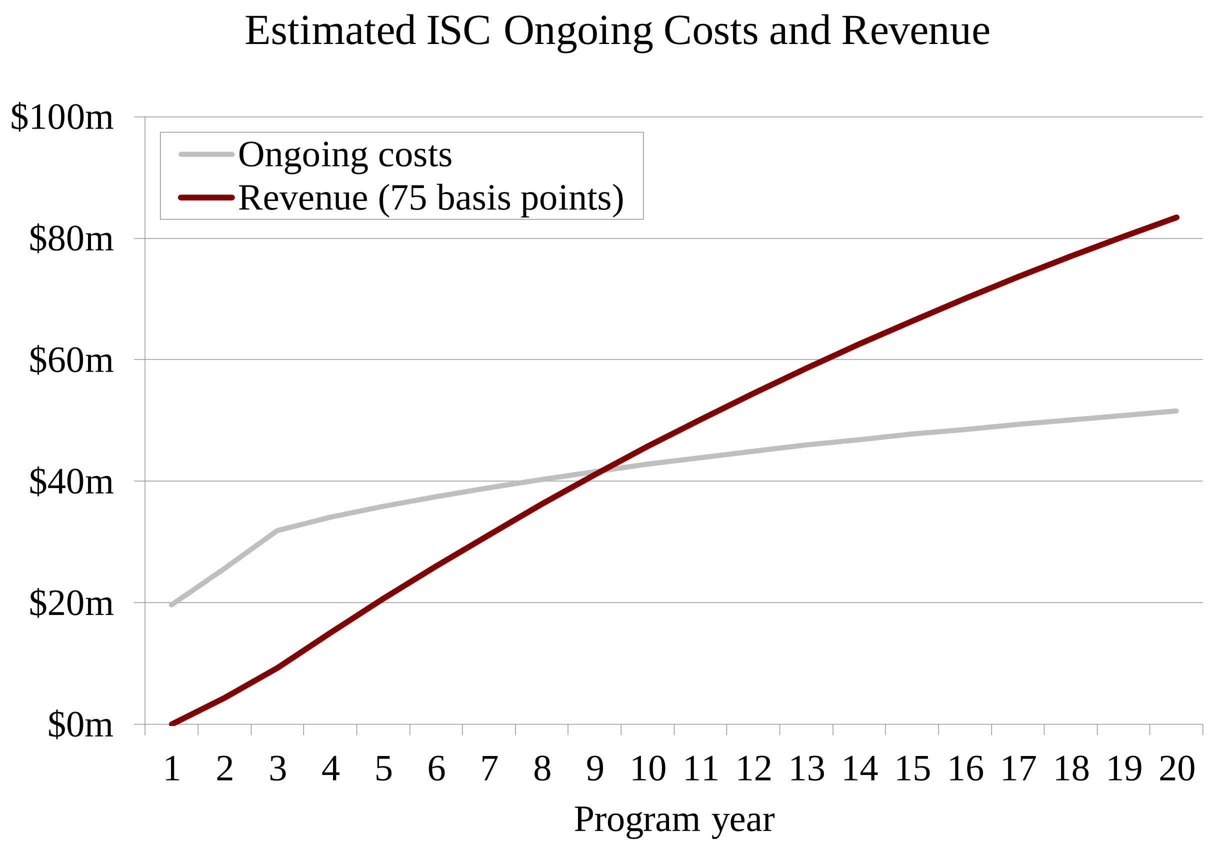
Cost per employer x # employers

Total ISC costs

Thus, ongoing costs climb quickly while revenue grows slowly.

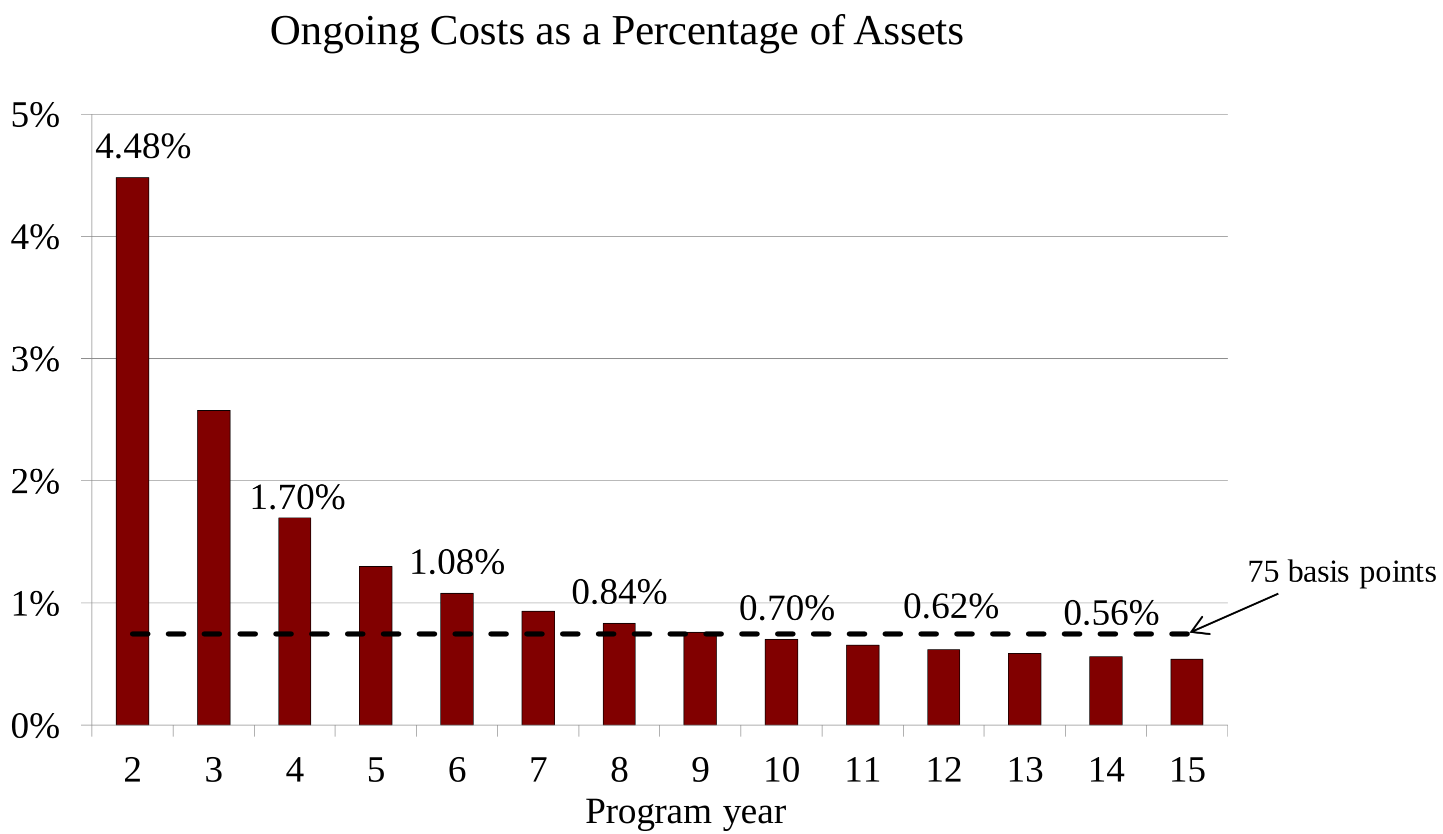
- Under the initial scenario, ongoing costs quickly escalate as the program is rolled out.
- But revenue is based on account balances – so initially these new accounts are small and generate little revenue.
  - The average full-time uncovered worker in Illinois makes $38,000 – contributing $1,100 a year at 3 percent.
  - This generates about $8.50 in revenue at 75 basis points.

Under initial assumptions, ongoing costs exceed revenue for nine years.



Source: CRR calculations.

Over time, average balances grow, and costs fall as a percentage of assets.



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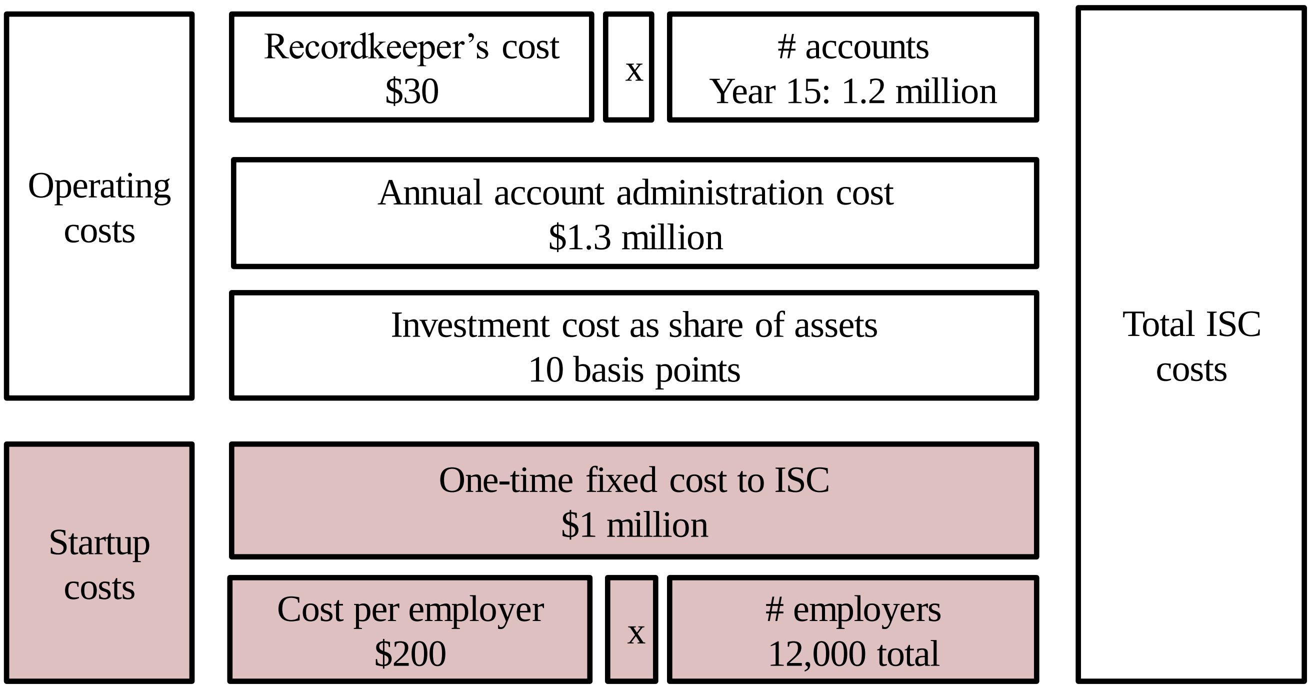
The ISC deficit depends on initial operating losses and implementation costs.



Other states have considered various ways to deal with these initial losses.

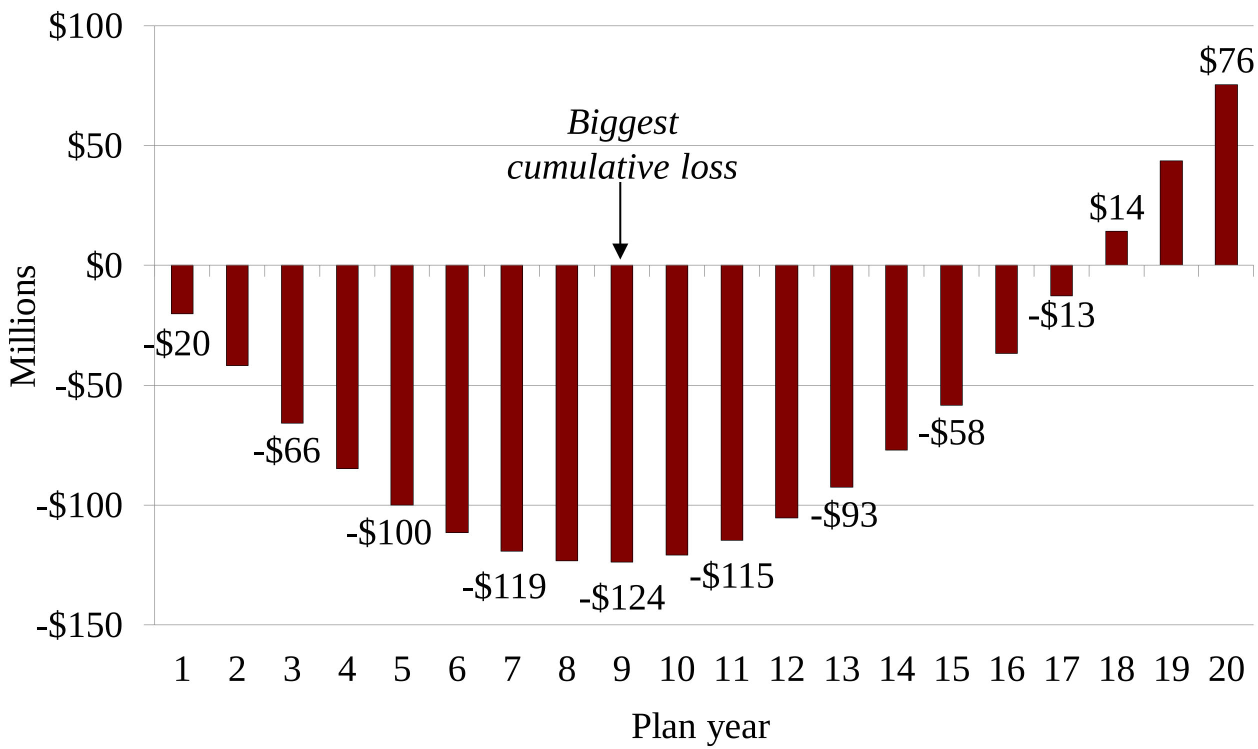
- The simplest is to give a recordkeeper a contract long enough for total operating profit to exceed initial losses, but this can require charging higher fees given the 10-year limit.

- Another approach is to take out a loan to pay off some of the initial losses, with the loan repaid out of program revenue.

- CRR calculated both the length of time to pay off initial losses and the largest deficit.

Under the initial assumptions, the program will pay off startup losses in 18 years.

Projected Cumulative Deficit for ISC Under Initial Assumptions, by Year



Source: CRR calculations.

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Three options exist to improve the financial feasibility of the program.

1. Raise the default contribution rate.

2. Increase the initial fee charged on assets under management, allowing it to drop when possible or charge a fixed fee.

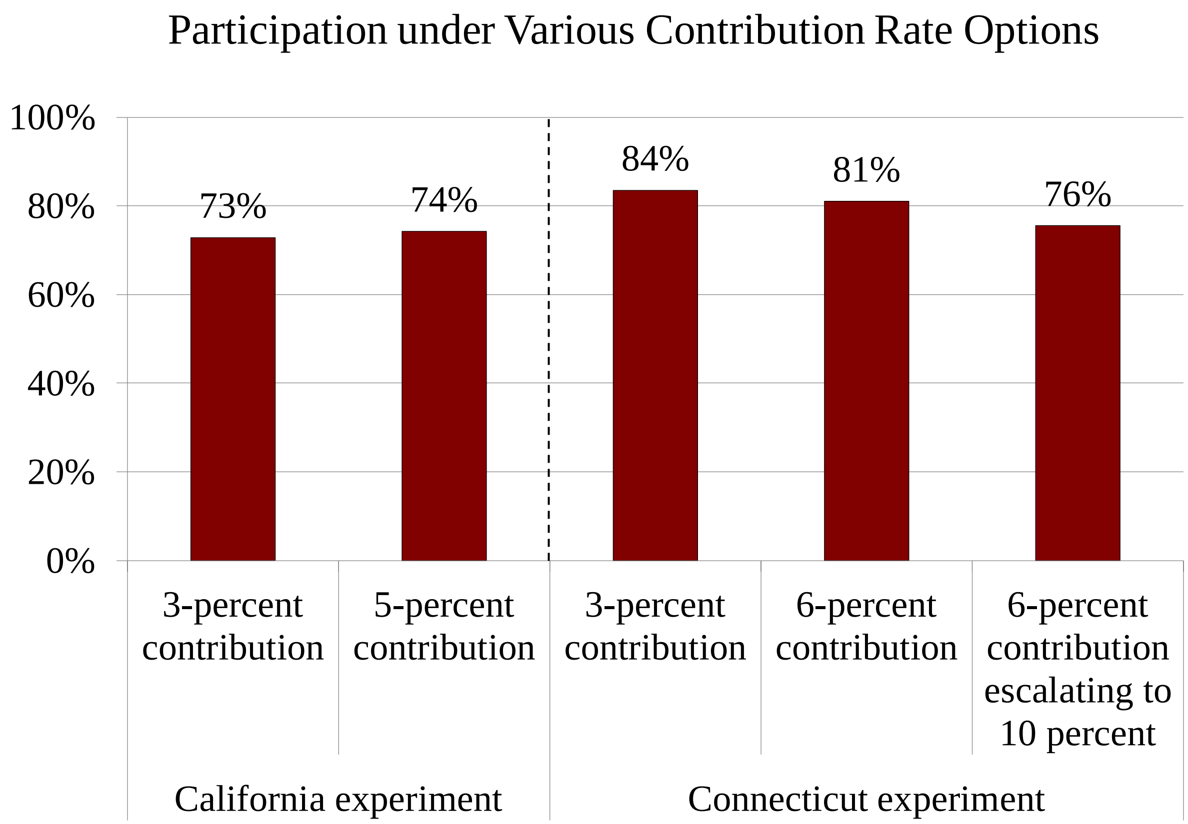
3. Significantly reduce costs.

Raising the default contribution rate typically triggers two concerns.

1. A higher share of the target population will opt out of the program.

2. A higher contribution rate will pinch the budgets of lower-wage workers.

In a variety of studies, participation has been high under defaults between 3 and 6 percent.



Sources: Overture Financial (2016); and State of CT Retirement Security Board (2016).

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Little direct evidence on the concern of pinched budgets is available.

- Studies have shown that lower income workers are no more likely to opt out of auto-enroll 401(k)s, but the impact of higher defaults on these workers is less clear.

- Lower income workers in 401(k)s without auto-enrollment are more likely to say money was a reason they did not contribute.

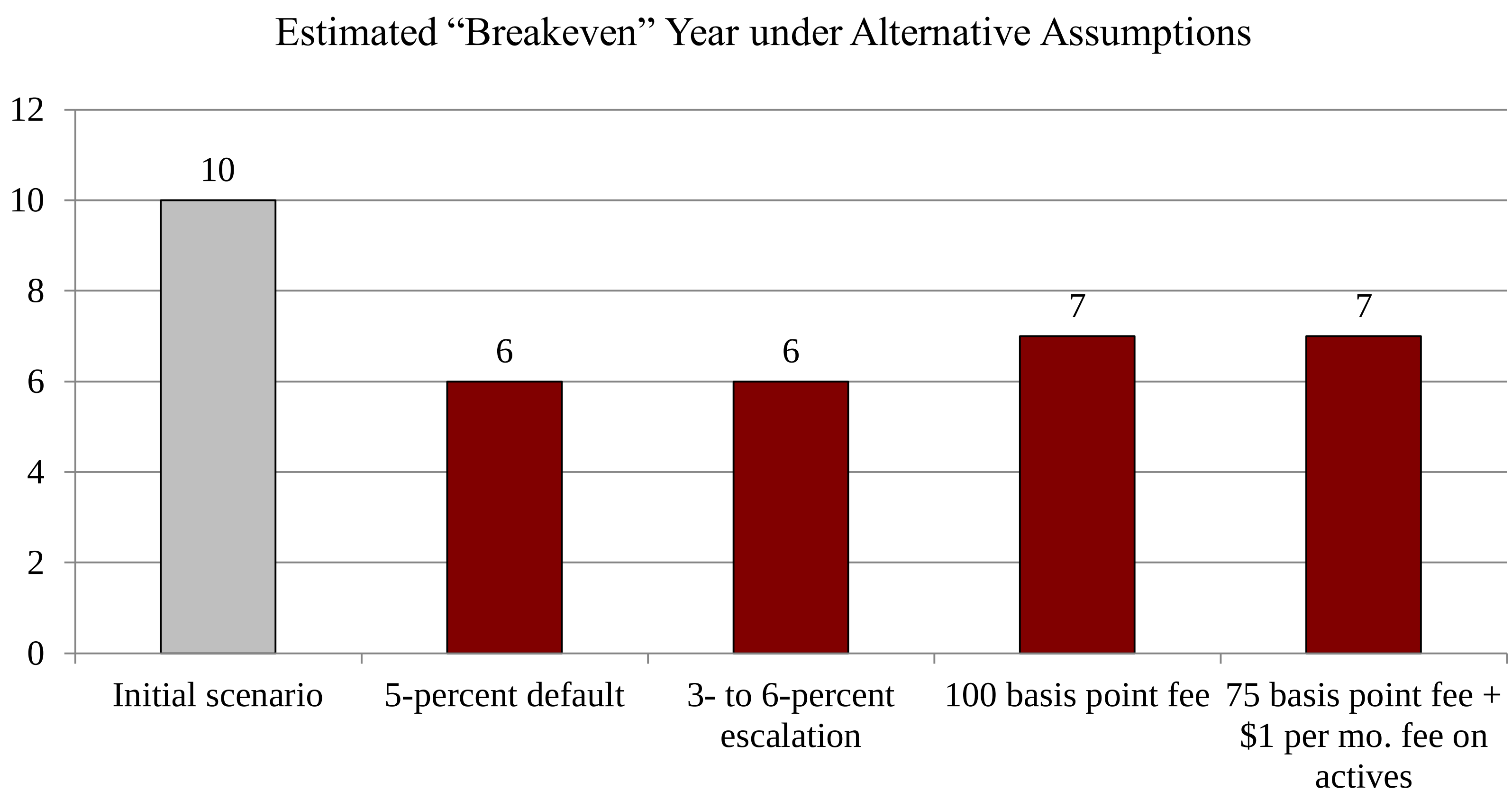
- Choosing a Roth IRA ensures that if workers feel pinched by a higher default, they can withdraw without penalty.

Increasing the fee on assets or charging a fixed fee on active accounts is also possible.

- Oregon decided to charge 100 basis points on assets under management initially, with the plan to decrease fees during the next contract period.

- Alternatively, charging a fixed-dollar amount per active account early on in the program can alleviate the tension between per account costs and low initial balances.

The length of time to break even is shorter with alternative contributions or fees.



Source: CRR calculations.

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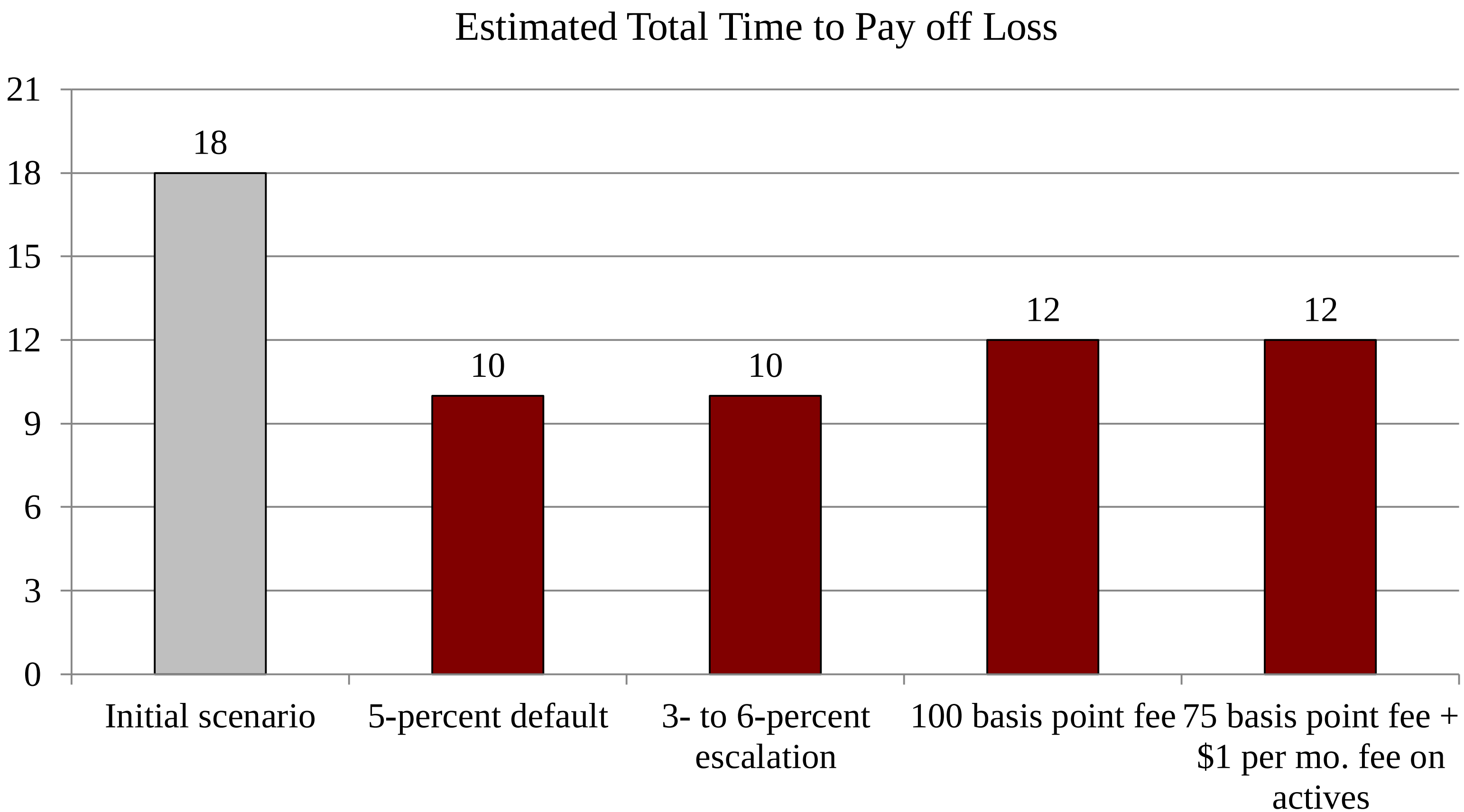
Higher contribution rates can reduce the time to become net positive to less than a decade.



Source: CRR calculations.

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It is less clear how costs could be lowered below the current assumptions.

- The per account cost of $30 reflects the cost of keeping records for IRAs and is consistent with:
  - 401(k) accounts;
  - Other state's estimates of Auto-IRA costs; and
  - ABLE accounts.

- The startup cost of the program is relatively low due to the exclusion of firms with under 25 employees from the mandate.

Conclusion

- Under a 3-percent default and 75-basis point fee, the ISC program could take more than a decade to become net positive.

- But a higher default contribution rate or higher fee structure can significantly shorten this time period.

- The evidence suggests higher defaults are most effective and are unlikely to discourage workers from participating.