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STATE AUTO-IRA PROGRAMS: THE KEYS TO FINANCIAL SELF-SUFFICIENCY

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Introduction

Very few workers save for retirement unless their employer offers them a retirement plan, typically a 401(k). But only about half of all private sector workers currently has access to such plans. In the absence of federal action to close this coverage gap, several states have stepped in. California, Connecticut, Illinois, Maryland, and Oregon have passed laws that will require employers without a plan to automatically enroll their workers in a state-sponsored program of Individual Retirement Accounts ("auto-IRAs"). These programs would be administered by private sector companies, with oversight by the state.

States that have passed auto-IRA laws face a challenge: these programs must pay for themselves. Addressing this challenge is difficult because, in the beginning, program costs will rise more rapidly than revenues. Costs are driven by the number of accounts, and the programs are expected to enroll many participants in the initial years. In contrast, revenues are driven by assets under management, which are initially low as employee contributions and investment returns take time to accumulate. These facts suggest that, unless the fees charged to participants are set prohibitively high, it may be a number of years before state auto-IRAs "break even" and pay back any initial losses. This *brief*, which is based on a study for the state of Oregon's Retirement Savings Plan, will: 1) examine what fees may be required to enable auto-IRA programs to be self-financing; and 2) identify the most important drivers of, and barriers to, financial self-sufficiency.[1]

The discussion proceeds as follows. The first section describes the costs of an auto-IRA program, including the start-up and ongoing administrative costs. The second section describes how program assets accumulate, resulting in higher revenue from fees. The third section discusses how costs and asset balances interact to dictate program finances, and how long it may take for auto-IRAs to break even as well as to pay back any initial losses. The final section concludes that auto-IRA programs can break even and pay back initial losses in about 9 years as long as: 1) initial fees are allowed to be higher in the short-run – around 100 basis points – before dropping down to their long-term equilibrium; 2) the default contribution rate is meaningful; and 3) per-account costs are relatively low.

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Program Costs

Auto-IRA programs have two basic types of costs: 1) start-up costs; and 2) ongoing costs, which include maintaining individual accounts, administering the program, and managing investments.

Start-up Costs

Start-up costs reflect two realities: 1) to date, no auto-IRA program exists; and 2) a plan administrator must establish connections with thousands of employers to get data for automatic enrollment and to process payroll deductions. Since auto-IRA programs have no existing model to draw on, the program will need to develop new rules, procedures, and infrastructure. In Oregon's program (the Oregon Retirement Savings Plan or ORSP), such fixed costs were estimated to be about $1 million. The need for plan administrators to establish data connections with thousands of employers means that the state must anticipate an additional one-time charge for each employer in the program.[2] The Oregon study assumed that it would cost approximately $200 per employer to set up these interfaces for 51,000 employers.[3] The net result is that the program's start-up costs would be approximately $11 million (see Figure 1).[4]

Figure 1. Summary of Start-up Costs for ORSP

One-time fixed cost
$1 million

Cost per employer
$200

x

Employers
51,000

Total estimated start-up costs
$11m

Source: Authors' calculations.

Ongoing Costs

Ongoing costs are for maintaining individual accounts, administering the program, and managing investments. Most important is the fixed cost associated with maintaining each account, which includes sending participants regular statements, processing changes in investments and contribution rates, and resolving questions through a call center. In Oregon, the fixed cost of maintaining an account may be about $35 per account per year.[5]

The total administrative costs depend on the number of accounts. Auto-IRA programs have two types of accounts: active and inactive. Active accounts are held by workers whose employer has auto-enrolled them in the state's program and who have not "opted out." The Oregon study assumed an opt-out rate of roughly 25 percent.[6] Inactive accounts come from employees who exit the program and do not close their accounts. Inactive accounts represent a challenge because the workers are no longer contributing but are still costing the program money. And because the type of workers who currently lack access to retirement plans at work tend to change jobs and/or become unemployed frequently, auto-IRA programs may end up with many inactive accounts.

In addition to the annual cost per account, an Auto-IRA program will incur administrative costs for program governance, communicating with employers and employees, and staffing. In Oregon, these costs were assumed to be roughly $1.3 million per year.[7] The final type of recurring cost is for investment management. With large asset pools, these costs should be about 15 basis points (0.15 percent of assets). It is worth noting that this 15-basis-point fee is not charged directly to the participant but rather must be covered by the overall program fee that they pay. Figure 2 illustrates the ongoing costs of the program.

Figure 2. Summary of Ongoing Costs for ORSP

Recordkeeper's cost
$35

x

accounts

Annual administrative cost
$1.3 million

Investment cost as share of assets
15 basis points

Total ongoing costs

Source: Authors' calculations.

Asset Balances

Program revenues come from assets under management, and the accumulation of these assets depends both on the money that comes into the program through contributions and investment returns and on the money that leaks out of the program through participant withdrawals.

Money In

Total contributions depend on two factors: 1) the average participant contribution rate; and 2) the average participant's income. In Oregon, workers were assumed to initially contribute 5 percent of their pay, with auto-escalation over time to 10 percent.[8] To determine the contribution amount, the contribution rate is applied to the average income of full- and part-time workers, which for Oregon was $40,000 for full-time workers and $15,000 for part-time workers.[9]

Once contributions are made, the return on investments determines how fast they grow. Since most states, including Oregon, anticipate offering a target date fund, the real returns were assumed to be just below 4 percent accounting for fees. However, the return on assets is not a key assumption for program feasibility in the short term, since the level of assets early on is driven primarily by contributions.

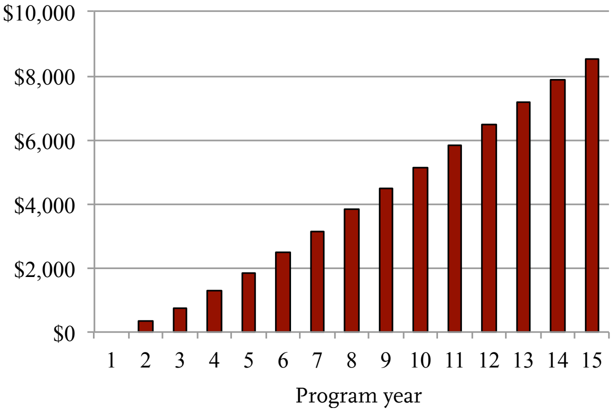
Money Out

Money can exit the program in one of two ways: 1) through in-service withdrawals; or 2) through an account closure (cashout). Account closures are likely to be more frequent in state auto-IRA plans than in 401(k)s because, again, workers at firms without retirement plans are more mobile than 401(k) participants and are more likely to become unemployed. On average, the Oregon study assumed that 7-8 percent of assets in a given year would exit the program.[10]

Total Assets and the "J-Curve"

Figure 3 shows that assets in the ORSP are low initially and then grow to a more substantial level as the program is rolled out to more workers and investment returns accumulate. The level of assets in the program is important because higher assets require lower fees per dollar to generate a given level of income.

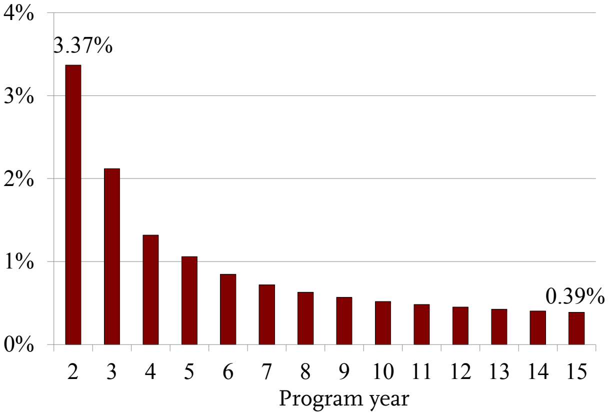
Figure 3. Estimated Total Assets under Management for ORSP, in Millions of Dollars



Source: Authors' calculations.

Figure 4 illustrates how required fees fall as a share of assets as calculated for Oregon. The curve is shaped like a "J" – the percentage is very high at first but falls in the long run to 0.39 percent of assets. Critics of auto-IRAs often point out that even the long-run cost of an auto-IRA program is above the cost of an IRA from a provider like Vanguard, which can be as low as 0.18 percent of assets. While this cost differential does exist, it is worth noting that the state plans offer automatic enrollment and automatic payroll deductions, both of which are likely to increase participation well above what is observed for IRAs today. In other words, auto-IRAs may cost more than the IRAs currently on the market, but they also provide individuals with a more convenient and automatic way to save for retirement.

Figure 4. Estimated Ongoing Costs as a Percentage of Assets for ORSP



Source: Authors' calculations.

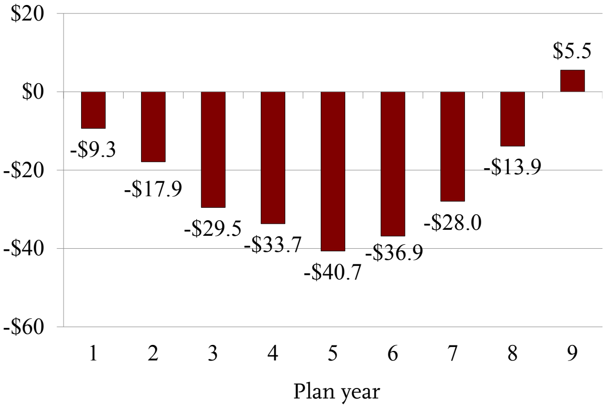
Program Finances

The pattern illustrated in Figure 4 means that states implementing IRAs have three options regarding how much to charge participants. First, they could have their programs break even immediately by charging fees far in excess of what many would deem "reasonable" but then allow fees to quickly drop as assets build up. Second, states could offer a middle-of-the-road fee initially and at some date in the future adjust the fees to the lower level allowed by scale. This approach means it will take longer for the program to turn a profit and could make it harder to find a private sector partner to administer the program. The final choice is to charge a low fee initially and for the foreseeable future. But this choice means large losses at first and a significant risk for any administrative partner. Oregon is thinking of taking the middle road and charging fees of 1.0 percent of assets initially, with the plan to charge lower fees later.[11]

Breaking Even and Initial Losses

If Oregon does proceed with a fee of 1.0 percent, the analysis suggests it would experience operating losses for the first five years and break even in the sixth. The program will, thus, accumulate operating losses in addition to the start-up costs. By Year 9, the initial start-up costs and accumulated operating losses will have been repaid (see Figure 5).

Figure 5. Estimated Cumulative Profits/Losses for ORSP, in Millions of Dollars

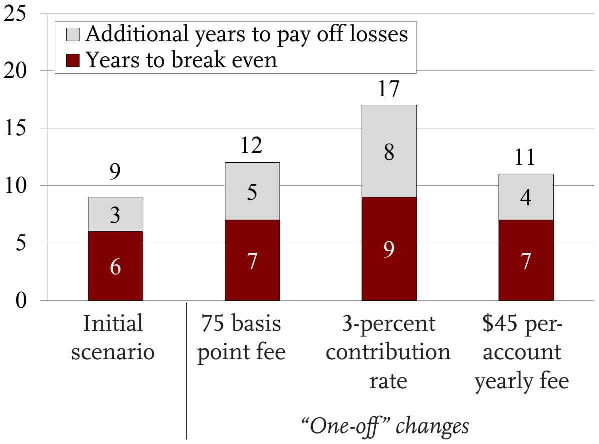


Note: The initial losses are less than the full start-up costs because Oregon is rolling out the program to employers gradually, so start-up costs are spread over the first 5 years.
Source: Authors' calculations.

Sensitivity Analysis

Under the assumptions laid out above, the Oregon program takes 9 years to break even and repay its initial losses and start-up costs. These results are particularly sensitive to three assumptions: 1) the fee charged on an account balance, which is a key determinant of program revenues; 2) the contribution rate, which dictates how fast assets will grow; and 3) the per-year cost of administering accounts, which is the most important cost driver. Figure 6 shows how long it would take for the program to break even on its cash flow and then pay off its start-up costs and initial operating losses under alternative assumptions.[12]

Figure 6. Time to Break Even and Repay Losses for ORSP under Alternative Assumptions



Note: The initial scenario assumes a fee of 100 basis points, a contribution rate of 5 percent (escalating to 10 percent), and a $35 per-account yearly fee.
Source: Authors' calculations.

Decreasing the initial fee to 75 basis points increases the length of time to break even and pay off losses from 9 to 12 years. Cutting the default contribution rate to 3 percent increases this length of time to 17 years, which is the largest effect of any single change in assumptions. Having a per-account fee of $45 instead of $35 has a slightly smaller effect, increasing the length of time to 11 years. In short, such potential implications should be considered carefully when developing the implementation plans for an auto-IRA program.

Conclusion

States implementing auto-IRAs want programs that pay for themselves and charge modest fees for participants. These goals are achievable even though the programs will incur initial losses due to non-trivial start-up costs, low assets, and fixed per-account costs; and these losses may take some time to pay off. The keys to success seem to be a willingness to: 1) charge higher fees in the short run or keep fees lower by financing start-up costs over a longer time period; 2) set meaningful contribution rates; and 3) keep per-account costs low.

Endnotes

1 See Center for Retirement Research at Boston College (2016) for the full report.

2 For example, vendors like Ubiquity that serve small businesses in the United States charge a per-employer fee to maintain an IRA-based plan (Ubiquity 2016) and pension providers in the United Kingdom serving small businesses also charge a one-time set-up fee (The People's Pension 2016).

3 This number was estimated by Bridgepoint/Segal, which was hired by the State of Oregon as a consultant on their program design. Sensitivities to higher employer enrollment costs (e.g., using a cost of $250 instead of $200) are presented in detail in the full report.

4 In the actual implementation of the program, these "start-up" costs will be incurred over several years since most states, including Oregon, envision rolling out the program to a few large employers first before expanding to smaller employers.

5 The full report based much of its work on an estimate of $30 per account, but more recent information has suggested that $35 may be more likely.

6 This estimate is based on analysis conducted by the authors for the State of Connecticut's auto-IRA program. The opt-out rate was allowed to vary by income, age, and part- versus full-time status with the approximate average reported here. For more details, see State of Connecticut Retirement Security Board (2016).

7 The cost of governance and communication is assumed to grow 1 percent faster than inflation and the cost of staffing is assumed to grow 2 percent faster than inflation over the course of the program. These costs were estimated based on Oregon's plans for staffing and communications and the state's typical pay raises.

8 This feature does not mean that the overall average contribution rate increases from 5 to 10 percent over the first five years of the program. Since new workers are always entering and some old accounts close, the average contribution rate never reaches 10 percent.

For example, even by Year 10 of the program, the average contribution rate is assumed to be just 7.3 percent. Alternative scenarios (e.g., using a fixed contribution rate of 3 percent) are presented later in the brief and in the full report.

9 These are participation-weighted averages by age, reflecting the fact that older workers have higher wages but are also more likely to opt out. If the wage were calculated as a simple average, it would be higher.

10 The Oregon study assumes that 20 percent of workers entering unemployment or exiting work covered by the auto-IRA plan (by switching to an employer who offers a retirement plan) close their account. Additionally, the study assumes any worker retiring or moving out of Oregon also closes their account. Estimates of the rate at which these events occur are provided in the full report, but the net result is that, in any given year, 6 percent of ORSP accounts are likely to close. The study assumes that accounts that close have balances equal to the average of all accounts. Because larger accounts are less likely to close than smaller ones, this assumption may overstate losses due to closures.

11 It is worth noting that while this fee is well above that of an IRA platform like Vanguard (see Vanguard 2016), it is also well below the fees on 401(k)s charged to small plans (BrightScope 2016).

12 For more sensitivity analysis, see the full report. The results are less sensitive to participation rates and account closure rates than one might expect, since low participation rates or high account closure rates mean fewer assets but also fewer accounts. The effect of the rate of return assumption is minimal compared to the amount contributed. The effect of start-up costs is also somewhat low, since in the long run these costs are likely to become small compared to the program's scale.

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