

2009

Washington Voluntary Accounts

Report to the Legislature

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January 2009

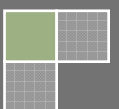


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Executive Summary

The recommendations in this report have been a moving target in an environment of unprecedented financial volatility and change. In May 2007, the Department of Retirement Systems (the Department) was charged with designing a retirement program to promote savings for private sector employees.

Since that time, the American stock market reached an all-time high, and to date has subsequently dropped over 45 percent, and currently exhibits unprecedented swings on a daily and weekly basis. The financial markets have fallen with the subprime credit crisis, and our nation's financial institutions are in the midst of novel government bail-outs.

The Department completed its assignment by identifying three options for a state sponsored retirement program for private sector employees. We benefited from research and other governmental efforts to tackle the shared looming potential of lack of retirement readiness of a significant portion of the population. We further were the recipients of advice and input from a broad range of stakeholders, such as worker advocates, academic professionals, financial institutions, insurance industry and association representatives, and retirement and investment experts.

The three options we identified are:

1. ***Private Sector Administered Payroll Deduction or Individual IRA offering a state specified low-cost, low-risk single choice inflation-protected simple investment.*** Any financial institution or eligible broker can administer and offer this product using the state's name if the product meets the Department's specifications. The Department will conduct marketing, including Web site referrals to eligible vendors, with the purpose of encouraging low-risk saving and reducing a current market mismatch between the supply and demand for low-cost products.
2. ***Private Sector Administered Payroll Deduction or Individual IRA offering a state specified low-cost, low-risk single choice inflation-protected and growth investment.*** This option achieves all of the same benefits as the simple investment option, but could offer a mixture of inflation protected investments in combination with a smaller amount of stocks. For example, the investment could be a balanced portfolio that consists mostly of principal preservation type assets (e.g., bonds) with a small amount of equities. The bonds guarantee that, at a minimum, an investor will receive every dollar invested back at its future value, and the stocks offer opportunity for some growth. This option is directed at longer-term retirement investment.
3. ***State Administered 401(k).*** The State could administer or partner with private sector providers to offer a 401(k) plan that would be available to private sector businesses. The plan design would be consistent with Internal Revenue Service Regulations and investments could be managed by the Washington State Investment Board. This option would require prior approval by the Internal Revenue Service (IRS) before it could be implemented.

The Department recommends the first option as a starting place, to encourage workers to begin saving. It is simple for individuals and employers, and it assists the private sector in marketing to a segment of the population they have had difficulty reaching. It maintains private sector administration of private sector retirement savings plans, providing a low-cost, consumer-oriented option for people who are currently left out of savings plans. It also reintroduces the concept that some savings should be in very

low-risk investments. The use of payroll deduction has proven an easy and convenient way to encourage employees to become savers. Future options like automatic enrollment could also increase the number of individuals saving for retirement.

The volatility and economic disruption of the time period in which we created our options inhibited the Department from finalizing a product for Options 1 and 2 due to the distractions facing the financial industry. We believe this can be a groundbreaking project. Should the Legislature choose not to establish the Washington Voluntary Accounts in the upcoming legislative session, the Department of Retirement Systems requests support from the Legislature to continue to pursue research and development of this important effort with our public and private partners.

Section One – Reasons for this Study and Proposals

The growing realization that a significant portion of the population may not be saving for retirement is emerging as a national social concern. The Washington State Legislature, with the support of stakeholders such as the Economic Opportunity Institute (EOI), has recognized the potential impact inadequate retirement preparedness may have on many of the state's citizens and the state's economy. The Legislature directed the Department to design a retirement program to promote savings for private sector employees, enlisting input from a comprehensive range of public and private sector stakeholders. They further directed the Department to develop a prototype Washington Voluntary Accounts (WVA) program and report recommendations to the Legislature (see Attachment 1, Substitute House Bill 1128, Chapter 522, Laws of 2007, Sec. 135).

The Legislature is not isolated in its concern. While it is difficult to estimate how well the general population is prepared for retirement, it is possible to estimate whether or not they are saving at their workplace – the primary source of most people's income.

Because workplace retirement plans are frequently popular with employees who have access to them, various state governments are considering what role the state has in making workplace savings plans available to all workers. Currently, employers have the option to provide or not provide these plans. Approximately 40 percent of Washington workers do not have access to a workplace retirement plan, and that number is nearly 50 percent nationally.¹

The growing national concern is continuously generating new research and proposals to address the problems. No quick, easy answers are emerging. The Department has incorporated ideas into its proposals from a broad range of stakeholders, including: proponents of government administered programs; private sector financial institutions and groups representing the financial industry; professional educators; retirement research experts; and legal advisors familiar with the current Internal Revenue Code. In addition, this report draws on information compiled from recent studies conducted on employer sponsored retirement savings plans and employee participation in those plans.

Why State Governments Might Seek to Promote Retirement Savings

Workplace retirement savings plans receive favorable tax treatment and are generally popular with employees who have access to them. State governments may, therefore, seek to find ways to make workplace savings plans universally available to all workers. These efforts may take the form of creating and offering retirement plans to uncovered workers or mandating that employers provide access to savings programs or accounts, or a combination of these approaches.

Governments, including Washington State, grapple with two primary questions in their deliberations over which actions to take. What is government's role in helping private sector employees save for retirement, and will their actions change existing savings behavior?

Governments have an interest in the retirement savings issue in that they are first and foremost concerned with the general welfare of the population. When senior citizens have adequate income in

¹ According to data compiled by the Employee Benefit Research Institute (See attachment #2).

retirement they are much more likely to remain independent and have choices about their living situations. Government also benefits when seniors have increased disposable income which results in increased discretionary spending and contributes to the economy of the state. Finally, there will be less need for government assistance because seniors are less likely to run out of money after they retire. The concern that many people may not be prepared to fund retirement throughout their post-work life is a combination of several factors:

Longevity and Health Care Costs

The post-war or baby boom generation is nearing retirement. This sizable population is the beneficiary of better health and longer life spans. In fact, longevity has increased two years every decade since 1960² while health care costs escalate.

Diminishing Number of Pension Plans

Defined benefit pension plans grew to be more expensive than anticipated due to the adoption of new benefit improvements and the cost of funding benefits over longer life spans. Before 1980, more than 50 percent of private sector employees who had a retirement plan at work were covered entirely by defined benefit plans. In 2005, just 10 percent or less continued to have defined benefit plans as their only retirement plan.³ This number is anticipated to further decline as private sector employers replace defined benefit plans with 401(k)s. The Pension Protection Act of 2006 responded to the threat of increasing defined benefit plan failures by imposing stringent funding requirements after some financially strapped companies with underfunded plans abandoned them, leaving people nearing retirement without an important asset they had counted on for wage replacement.⁴ These new funding requirements have further caused employers to abandon their defined benefit plans for less costly 401(k) plans.

The number of 401(k) plans has increased with the decline of defined benefit plans. Experience on some of the oldest plans indicates they require contributions between 10 percent and 23.5 percent to adequately fund a person's retirement. Recent market volatility demonstrates the risk of heavy reliance on investing primarily in equities without a gradual shift from equities to fixed income as a person moves toward and through retirement. This concept has spurred the recent growth of target-date or life-cycle options in many defined contribution plans similar to the option offered to Washington State Plan 3 and Deferred Compensation Program participants as of October 2008.

Savings

From 2005 through most of 2008 the national savings rate declined to nearly zero.⁵ Further, many people have invested their savings in equities lured by the bull market of the last two decades. If those investors do not increase their fixed investments and decrease their equities as they near retirement, they run the risk of having inadequate savings to fund their retirement living expenses. Younger investors who convert to investments that preserve capital in a down market and do not convert back

² U.S. Census Bureau Data show life expectancy increased by two years per decade since 1960.

³ Since 1980, defined benefit plans are steadily being replaced with defined contribution plans. Employee Benefits Research Institute, *What are the trends in U.S. retirement plans?*
<http://www.ebri.org/publications/benfaq/index.cfm?fa=retfaq14>

⁴ Pension Protection Act of 2006, 109th Congress, H.R. 4.

⁵ Based on data from the U.S. Department of Commerce, Bureau of Economic Analysis.

as the market recovers may also lose some of their savings value. These savings behaviors have prompted the rise of life-style savings funds that automatically adjust the asset mix over time without requiring the investor's day-to-day attention. The 2008 market decline has many individuals and even the experts concerned about whether or not their savings will be sufficient to see people through their retirement if the market decline is prolonged.

Social Security

Social Security will undoubtedly be preserved since it is the core of retirement income for over two-thirds of Americans. If no policy changes are made, actuaries project that 78 percent of promised benefits could be paid after 2041 when benefits exceed projected revenue.⁶ That 78 percent will provide more purchasing power than a new retiree gets today, but less than promised. Congress will have to act, but workers can depend on this core income.

Recent Efforts to Address Retirement Savings

Private-sector pensions and retirement savings have been almost exclusively a federal matter since before the enactment of the landmark Employee Retirement Income Security Act of 1974 (ERISA). Any effort to explore a state government role in promoting retirement savings requires an understanding of the most important actions that have been taken by federal regulators and Congress and the major proposals being considered by the federal government.

Federal Efforts

Steps taken recently to expand retirement savings and coverage stem from some key initiatives formulated by the United States (U.S.) Department of the Treasury during the past decade.⁷ These initiatives, summarized below, form much of the foundation for the state-assisted saving strategy which is the subject of this report.

In 1996, Congress enacted the SIMPLE-IRA, a mini-401(k) plan designed to expand retirement coverage by simplifying the process of adopting and maintaining retirement savings plans for small businesses. In the late 1990s, through administrative action, the Treasury Department defined and approved the Payroll Deduction IRA and the Automatic 401(k). The Payroll Deduction IRA was designed to expand the use of individual retirement accounts (IRAs) by enabling employees to save using direct deposit via their employer's payroll system. However, despite publicity and administrative guidance, the payroll deduction IRA is virtually unknown to employers and adoption has been minimal. The automatic 401(k) has proven to be successful. The ability to automatically enroll employees into a 401(k) at a default rate with advance notice increases employee participation from 75 percent to levels of 85 percent to 95 percent.⁸

⁶ *2008 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* (March 25, 2008, U.S. Government Printing Office).

⁷ The discussion here does not extend to federal measures and proposals relating to defined benefit pension plans, funding of those plans, employer stock in 401(k)s, and other matters that are less germane to the subject matter of this report.

⁸ William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings," The Retirement Security Project, No. 2005-1 (Washington, D.C.,: Mar. 2005), [http://www.retirementsecurityproject.org/pubs/File/Automatic401\(k\).pdf](http://www.retirementsecurityproject.org/pubs/File/Automatic401(k).pdf)

In 2001, Congress enacted the Saver's Credit, which provides tax incentives for workers in lower tax brackets who derive comparatively little benefit from the deductibility of pension contributions. It is currently used by about 5 million taxpayers each year, and is the only major statutory provision targeted directly at increasing coverage and retirement savings for moderate- and lower-income workers. Other legislative proposals, including some that were endorsed by President Obama during his campaign, are pending to expand and restore the Saver's Credit to its original design as a refundable 50 percent tax credit deposited to the 401(k)s and IRAs of contributors who earn up to \$75,000.

Other legislative efforts are being considered at the federal level and have received hearings recently. One is the "Automatic IRA," a proposal that was co-authored by Brookings Institution senior fellow and former Treasury official Mark Iwry and Heritage Foundation senior fellow David John, under the auspices of the Retirement Security Project.⁹ The Automatic IRA would seek to cover American workers who have no retirement savings coverage by assisting employers that are unwilling or unable to sponsor any retirement plan for their employees to automatically enroll employees in payroll deduction IRAs.

Another proposal to expand coverage has been suggested by Teresa Ghilarducci, a professor of economic policy analysis at the New School for Social Research.¹⁰ This proposal would eliminate tax deferrals for 401(k) plans and would use the resulting revenue gain to finance a new federally managed Guaranteed Retirement Account program that would make employee contributions mandatory for those not participating in another plan. Accounts would accumulate earnings at a guaranteed rate of 3 percent above inflation.

State Efforts

Many academic institutions and organizations interested in public policy are studying ways to increase savings to help people improve their retirement readiness. The Economic Opportunity Institute (EOI) in Washington State supported Substitute House Bill 1128, Chapter 522, Laws of 2007, Sec. 135 which initiated this report and other state efforts. The AARP also promotes the concept of "State Ks" – 401(k) plans sponsored by state governments available to all employers.

Other state governments have considered programs to assist private sector employees who do not have access to employer sponsored retirement plans. These programs vary in complexity, but are all aimed at increasing the number of employer sponsored savings plans using the assumption that if the plan is available, employees are more likely to save for retirement.

The Maryland State Legislature requested a study to determine the feasibility of a state-sponsored voluntary employee accounts program. The report concludes that such a program could be implemented, but would incur a significant state expense before it could be self-supporting.¹¹

⁹ Iwry, Mark and John, David, Pursuing Universal Retirement Security Through Automatic IRAs, The Retirement Security Project, 2007-2, Washington, DC. The Retirement Security Project is supported by The Pew Charitable Trusts in partnership with Georgetown University's Public Policy Institute and the Brookings Institution. And Joint testimony of David C. John and J. Mark Iwry before the Subcommittee on Long-Term Growth and Debt Reduction of the Committee on Finance, U.S. Senate (June 29, 2006)

¹⁰ Teresa Ghilarducci, "Saving Retirement in the Face of America's Credit Crises: Short Term and Long Term Solutions," Oral testimony, Committee on Education and Labor, October 7, 2008

¹¹ The Maryland Voluntary Employee Accounts Program study is available online at: http://dlslibrary.state.md.us/publications/JCR/2007/2007_63-64.pdf

A bill introduced in California would have required the California Public Employees' Retirement System (CalPERS) to offer individual retirement accounts for private sector and nonprofit employees. The bill stated that the program would only be implemented if it was approved by the Internal Revenue Service, and was to be operated on a self-sustaining basis.

In Connecticut, a bill was introduced that would have required their Comptroller to establish a tax-qualified defined contribution retirement program for self-employed individuals, businesses with 100 or fewer employees, and nonprofit organizations. The Comptroller would minimize costs by helping small employers and individuals purchase retirement savings plans and investments through economies of scale, standardization and other measures. A third-party administrator was to manage the plan(s), and expenses incurred to initiate, operate and administer the program were to be recovered from program assets.

Although the California and Connecticut proposals made significant progress through the legislative process, neither proposal was passed into law. Future actions on these bills are unknown at this time. However, proponents intend to move forward with the concepts in subsequent legislative sessions.

Section Two – The Workplace Retirement Savings Environment

As of the later part of 2008, our nation's savings rate was hovering near zero.¹² How much of this low saving rate translates into inadequate retirement readiness of the general population cannot be easily calculated. Dallas Salisbury, President and CEO of the Employee Benefits Research Institute (EBRI), observes that the incidence of individuals saving for retirement has remained relatively constant as a percentage of the population in recent history. While conditions are changing as DB plans decline, the percentage of people planning for retirement today is not much different than it was 30 years ago, although that may change given the current environment.

Can an increased availability of workplace retirement plans change this behavior pattern and increase the percentage of people saving for retirement? The use of available savings plans or products by individuals appears to be affected by at least four factors related to the individual:

1. Worker demographics such as age, education, employment status and income level
2. Motivation to save
3. Financial awareness or literacy
4. Automatic enrollment

The adequacy of an individual's retirement savings and preparation appears to be affected by three environmental factors:

1. Increasing longevity
2. Increasing healthcare costs
3. Fluctuating economic conditions

The prevalent concern that a retirement "crisis" is emerging is based on the anticipated impact of the environmental factors on the historical population's savings behavior. Without an upward adjustment in the retirement age, people will live longer in their retirement years. Healthcare costs increase faster than general inflation, and most of an individual's lifetime healthcare expenses can be expected to be incurred in their later years. Fluctuating financial markets may change the value of their only income producing assets. Workers today are faced with a new reality that they may not have the resources necessary for adequate income replacement once they stop working.

Motivation and Barriers to Save for Retirement

Data demonstrates and logic dictates that younger workers' primary focus is on saving for near-term demands including purchasing a house, saving for their children's education, or creating a cushion in case of job loss or other unexpected events.¹³ Some younger workers are able to begin making smaller contributions toward their retirement, which can increase as priorities shift. Many workers reach the stage where they can make more significant contributions to their retirement in their 40s, 50s and 60s.

¹² Based on data from the U.S. Department of Commerce, Bureau of Economic Analysis

¹³ Investment Company Institute Research Perspective Vol. 14, No.2, September 2008

Higher income households reach the ability to save for retirement sooner than lower income households. Others are able to save as their income increases later in life, or when they are not faced with unexpected hardships such as job loss, high medical expenses or other current financial challenges. For lower and middle income workers the best strategy may be to start saving early and over the long-term make smaller, but consistent contributions to a retirement account. However, some lower income workers find it difficult to set a significant amount aside at any time during their working years.

Other barriers are more controllable, but may still inhibit savings. These include lack of knowledge about the mechanics of saving, where and how much to save, and how to safely invest. Parents in their 50s and 60s, faced with preparing for retirement and regretting their lack of understanding, know firsthand the challenge their young adult children face in deciphering the right investment choice, the right fee structure and other basic consumer decisions. There is growing speculation that too many choices and too much information have caused inertia for some people to begin investing for retirement.

Department of Retirement Systems data shows that out of twelve investment options in Plan 3 and the Deferred Compensation plan, people on average choose three options. This leads to the question does three or twelve better serve the average employee/investor?

The Role of Employer Sponsored Retirement Plans

Consensus exists that workplace retirement plans are generally more successful than individual effort outside of employment. Data and opinions about how and why they work vary. One line of thought is that if they are available, workers will save if automatic payroll deduction is arranged by the employer. A second line of reasoning is that the law of supply and demand applies – employers will supply retirement plans when their workforce desires them.

This variance in views results from the difference between data from various surveys and observations of what happens in actual practice. Further, this variance in views is a key source of the reasoning behind different recommendations regarding workplace retirement solutions.

Data from sources we reviewed is consistent in the observation that large employers are more likely to sponsor retirement plans than small employers. Data is also consistent that employees with higher household incomes are more likely to prioritize saving for retirement than employees with lower household incomes.

The 9th Annual Transamerica Retirement Survey conducted by the Transamerica Center for Retirement Studies shows that workers with annual household incomes greater than \$100,000 prioritize saving for retirement, and that workers with annual household incomes less than \$50,000 find being financially stretched the most significant factor in preventing them from saving for retirement. Even so, 46 percent of those surveyed making less than \$50,000 indicate they are saving for retirement outside of work.¹⁴

Even though employees with lower household incomes have more difficulty prioritizing saving for retirement, they still value doing so. The Transamerica survey data shows that an increasing number of full-time workers believe employee-funded, or self-funded, retirement plans will be their primary source of income during retirement.

¹⁴ 9th Annual Transamerica Retirement Survey by the Transamerica Center for Retirement Studies

Which Employees are Attracted to Workplace Retirement Plans?

The Transamerica survey data shows that 50 percent of those surveyed have a preference for superior retirement benefits over a higher salary and that 61 percent of workers whose companies do not offer a retirement plan are more likely to leave their current employer to take a nearly identical job with a similar employer if that employer offers a retirement plan.

This may be consistent with recent research by the Investment Company Institute (ICI) that shows that private sector employers are more likely to offer retirement plans if their employees value the benefit.¹⁵ The researchers, Peter Brady and Stephen Sigrist, conclude that employer decisions to sponsor retirement plans are not random. Employers compete for workers, and generally offer the least costly combination of compensation and benefits that attracts and retains a qualified workforce.

Employee demographics appear to play a significant role in determining if an employee is attracted to an employer-based plan where they can save for retirement according to the ICI research. The researchers' survey data indicates that people save for various reasons during their earning years. Younger and lower-income households focus their savings goals on consumption such as education, purchasing a house or saving for unexpected needs. Individuals or households with low lifetime income may never set a retirement savings goal, instead relying on Social Security for their primary income. The study results indicate that workers in these demographics are less likely to work for an employer that sponsors a retirement plan, finding that only 27 percent of workers without access to a workplace retirement plan are likely to have the ability or focus to save for retirement.¹⁶

How does Employee Participation in Plans Develop?

ICI researchers found that participation in an employer sponsored plan is related to employee characteristics, not simply plan availability. Employees who are focused on saving for retirement tend to be older and/or have higher income households with higher levels of education. Employers who seek to recruit and retain these employees offer retirement plans because it is an important benefit these employees seek in determining where to work. Larger employers do appear to be more likely to employ these types of workers, but small employers who employ workers with these characteristics are as likely to offer a retirement plan as are large employers. Eighteen percent of workers at firms with fewer than 10 employees have an employer that sponsors a plan compared with 71 percent of workers at firms with 1,000 employees or more. Approximately 80 percent of employees in this research participate in their employer's plan if offered, regardless of the size of the business.¹⁷

Barriers to Employer Sponsored Plans

The Department contacted a variety of research institutions, financial institutions, financial professionals and business associations to identify the barriers employers may face in sponsoring retirement plans. Time and cost to set up a plan, time to administer the plan and cost of on-going contributions are three

¹⁵ Investment Company Institute Research Perspective Vol. 14, No.2, September 2008

¹⁶ Ibid

¹⁷ Ibid

barriers employers face in offering workplace plans.¹⁸ Larger businesses with human resource departments can leverage economies of scale, while small business owners have to multi-task and face formidable time challenges while learning about available plans and which type of plan might be right for their business.

Jeff Seely, founder and former CEO of ShareBuilder Corporation (ShareBuilder), a Washington State based business acquired by ING in 2007, observes that many small businesses want to provide a plan to their employees, but are inhibited by the cost, complexity, and time required. ShareBuilder found that these employers need a simple solution and were willing to work with an online-only model. At the same time, they found that a portion of very small businesses are focused on the day-to-day business of surviving and providing retirement benefits is not a priority.

ShareBuilder also found employers were willing to install a plan in response to employee demand, and in recent years many companies used a 401(k) plan as a recruiting tool. Making these online tools available through a trusted retailer gave employers added confidence in making the purchase decision. ShareBuilder found low plan cost and investor-friendly investment choices such as Exchange Traded Funds were important factors in selecting among 401(k) plan providers.

Time, cost and effort to set up a plan do not seem to be seen as productive by the employer if their employees do not wish to participate. Employers seem less willing, and seem to have no desire, to offer this type of benefit if few or no employees use it. Small employers with mobile employees appear to be highly unlikely to offer retirement plans.

Demands on small business owners' time limits not only the amount of time they have to set up a plan, but even more so the amount of time they have to research which plan is right for them. The financial industry does not ignore this need. In fact, it appears many banks and brokers not only try to attract small business clients to retirement plans, but have designed low-cost products they believe fit this market's needs.

The primary obstacle, therefore, may be a mismatch of supply and demand. Small business owners need an easy, quick, simple plan. The supply side, with each vendor trying to compete and differentiate its product, can overwhelm the business owner buyer with choices they don't have time or energy to review.

¹⁸ *The 2003 Small Employer Retirement Survey (SERS) Summary of Findings*. Employee Benefit Research Institute, American Savings Education Council, and Mathew Greenwald & Associates, Inc.

Section Three – Theory

Our Approach to Developing Options

The Washington State Legislature took an early step to consider the threat of lack of individual retirement readiness by authorizing the Department to design a state sponsored savings program for private sector employees. The Department recognizes that early efforts, or first movers, break new ground. A state sponsored retirement savings program for private sector employees breaks cultural, operational and legal norms, although several efforts are now moving in concert with Washington State.

The Department developed its proposals during a period when few other proposals had yet been developed. We acknowledged the sensitivity of this responsibility by respecting the interests of all involved stakeholders. We approached this project without preconceptions, and were open to any solution that might address the underlying concern that workers need viable tools and assistance with which to save for retirement. Subsequent to our fieldwork, several proposals have been developed as referenced in “Recent Efforts to Address Retirement Savings”.

Our work included:

- Developing and testing the principles and goals upon which we base our recommendations;
- Studying emerging proposals of other states, presidential candidates’ positions, and organizations advocating a national program;
- Meeting and discussing our solutions with sponsoring stakeholders, other governments, other interested advocacy organizations, finance and retirement professors, retirement professionals, research organizations, financial institutions, financial institution associations, and investment professionals;
- Exploring with legal counsel all existing tax-deferred and related plan designs allowable under the Internal Revenue Code; and
- Selecting and presenting three options for consideration by the Washington State Legislature.

Goals

The environment in which this project was conducted is evolving. This volatility is a result of a large aging population reaching retirement age, anticipated increased life spans past traditional working ages, increasing health care costs, an unprecedented financial downturn with unpredictable outcomes, and other significant government efforts. Our goals listed below were influenced by this environment:

- Address the question “Is there an appropriate role for government in helping private sector employees save for retirement?”
- Obtain and fairly characterize input from a representative group of stakeholders.
- Increase the percentage of people who save for retirement.
- Develop multiple options and next steps for state involvement in private sector retirement savings ranging from a public/private partnership to full state involvement.

Premises Used in Developing this Report

The problem being addressed by this project - a population financially unprepared for retirement in the next 20-30 years - is speculative at this point. While data indicates (and most experts agree) the probability is high that many people are inadequately or improperly prepared for retirement, the realization can only be documented after the fact. The Department further recognizes that state sponsored programs offered to private sector workers is a new concept that must be carefully coordinated with stakeholders to avoid unintended consequences or unnecessary conflict.

With the commitment to respect all stakeholder interests, we developed a range of potential options that we believe address the underlying problem and meet the intent of the Legislature based on the following beliefs:

- Government has an interest in assisting individuals to be self-sufficient in retirement to reduce dependence on government resources.
- Private sector businesses, financial institutions and government can cooperate effectively to increase the general population retirement readiness.
- Choice is an obstacle to many businesses and individuals. Small businesses do not have the resources to explore optimal solutions for retirement plans, even if the financial industry provides them with low-cost options. Most individuals do not have the resources or the training to choose the plan or investments that best fit them, and subsequently defer that decision.
- A market mismatch exists between the supply and demand of products developed for those businesses and individuals for which choice is an obstacle. Too many products exist to compete for the characteristics of this market segment.
- Retirement is no longer well defined. Calculating retirement needs is challenging and daunting for most people, providing incentives to defer or avoid planning.
- Saving something is better than saving nothing. All retirement plans do not necessarily have to be an all-in-one solution.
- Many individuals and families experience times in their lives when they are focused on immediate needs and choose not to set aside funds for retirement.
- Tax deferred plans are not necessarily attractive or beneficial for lower income individuals and households because they may save no taxes with a deferred plan due to their low tax rate. They benefit from growing more dollars earlier and withdrawing during retirement at a similar tax rate to their earned income.
- The financial markets provide an abundant offering of retirement products making choice selection, for the average consumer, a daunting and discouraging task.

- There is a portion of retirement savings that some people cannot afford to lose and therefore should not invest in risky assets regardless of their age. There is also a portion that people can invest in growth investments.
- Annuities can be a good option for safeguarding retirement assets.
- Persuasion to save is necessary before people will access education and programs to save.
- Payroll deductions, automatic enrollments and widespread employer participation would ultimately enhance any savings program.
- Government has an impartial voice and unique role in persuading people to save.

Investment Approach

The popular notion that individuals know best how to invest their money has been tested with the growth in 401(k) or other defined contribution retirement plans over the last 30 years. These plans, which generally offer a mix of fixed, value and growth equity, and balanced options, allow the individual to select their asset mix.

Experience indicates this may not be a successful strategy for many people.¹⁹ While some individuals have the expertise to select their portfolio mix, most people don't have the time to learn this specialized skill. Analysis of the Department's information demonstrates that the overwhelming majority of members contributing to the state's Plan 3 and Deferred Compensation Program plans rarely adjust their asset mix after their initial selection. This is one of the reasons most plans, including Washington State²⁰, have introduced life-cycle funds which automatically rebalance and adjust the asset mix based on a target retirement date.

The extraordinary market growth of the last two decades has led many people into investing in equities, potentially overweighting their portfolios in this asset class. Industry professionals have encouraged this philosophy on the basis that increasing longevity will require people to continue to grow their assets after retirement. They suggest that moving into fixed income investments at retirement will not see most people through their entire life, and most now advocate life-cycle funds similar to Washington State's Retirement Strategy Funds. The approximately 45 percent decline in the 2008 market is consequently stressing retirement portfolios based in equities and is particularly difficult for people in or nearing retirement.

Zvi Bodie, finance professor at Boston University School of Management, an expert on retirement security and co-author of the leading finance textbook *Investments*, proposes a cautious approach to retirement. He is a strong proponent of inflation protected securities such as Treasury Inflation Protected Securities (TIPS) or I-Bonds.

TIPS are purchased in 5-, 10- or 20-year terms, and the principal increases or decreases with inflation or deflation. Interest is set when the bond is sold, and compounded on the inflation-adjusted principal.

¹⁹ "Can you afford to retire?" a Frontline coproduction video with Hedrick Smith Productions, aired May 16, 2006, PBS. Frontline is a production of WGBH Boston.

²⁰ Washington State Retirement Strategy Funds in the Deferred Compensation Plan and Plans 3.

They can be traded in the secondary market. I-Bonds cannot be traded in the secondary market. Interest is a combination of the fixed rate of return set at the time of purchase and a variable semi-annual inflation rate.

Professor Bodie suggests that these types of instruments should play an important role in everyone's retirement portfolio. "Inflation protected bonds, or instruments guaranteed to return the money you invest today at tomorrow's dollar value, are a critically important part of protecting your retirement from unexpected or prolonged market downturns," he states.

Professor Bodie stresses that not everyone is able to save throughout their lives, but when a person can save for retirement, they need to think about protection as well as, or even before, growth. Inflation protected assets are a valuable tool for securing a retirement. Growth assets, or equities, are a valuable tool for creating the type of retirement you want once your retirement has been secured.²¹

The Value of Annuities

The WVA program is primarily intended to encourage people to begin saving something, and does not specifically focus on creating a lifelong income stream. However, it is well understood that when people manage their own savings throughout retirement, they may create timing problems through their spending patterns. They potentially spend less than they desire, or risk running out of money too soon.

Annuities address this situation by enabling people to stretch their savings into monthly payments that continue for life. By pooling both risks and assets, they allow lifetime payments to individuals based on the average lifespan.

Annuity products can serve an important purpose in today's environment where people are regularly living a significant number of years beyond their retirement date. Many people are reluctant to purchase them, however, in case their lives are cut shorter than anticipated. Demand has not been high, but there are indications many people will reconsider their decision. Data from LIMRA International, a marketing and research group in Windsor, Connecticut, shows that annuity sales have grown 18 percent in the last two years, to \$257 billion in 2007 from \$217 billion in 2005. Further, many vendors are working to provide lower fee annuity products to address the cost of the lower dollar saving accounts.

Retirement Savings Plans

The Department recognizes that many types of retirement plans have developed over the years. The U.S. Internal Revenue Code (IRC) defines several existing retirement plan types. Following is a brief description of each, based on information provided from the legal services firm, Ice Miller LLP.

²¹ Professor Bodie has produced simulated models comparing a risk free investment with a typical growth investment. The simulations assume a 40 year career accumulation of contributions and a 30 year retirement payout period. The simulations show that even though the growth outcomes can be better than the risk-free outcome, there are times the growth outcomes turn out to be worse, even after a 70 year simulation. (See attachment #3).

401(a) Defined Benefit Plans

401(a) defined benefit plans are available to all employers. These plans offer a defined benefit at retirement based on a fixed formula. They require a plan document, and are subject to stringent funding rules to ensure solvency. The variability of the pension liability, funded status and required contributions has led many employers to shy away from or reduce their exposure to these plans. For employers wanting to maintain defined benefit plans, hybrid and cash balance plans with reduced employer risk have become more popular.

401(a) Defined Contribution Plans

401(a) defined contribution plans are available to all employers. These plans allow employers and/or employees to make contributions into the pension plan in accordance with the plan document. These types of plans include Money Purchase Pension Plans and Profit Sharing Plans.

401(k) Plans

401(k) plans, a type of defined contribution plan, are available to all non-governmental employers. A formal plan document is required, and the employer must provide a written plan summary to eligible employees.

These plans allow employees to make elective contributions into the plan in accordance with the plan document. The employer may also make contributions on behalf of the members. Employer contributions may take several forms including matching contributions and/or discretionary contributions. Discretionary contributions can be allocated as a percentage of the employee's compensation or in some other type of accepted proportional method.

The limit on total contributions to a defined contribution plan is the lesser of 100 percent of compensation or \$49,000 for 2009 (indexed for inflation thereafter). If an employer sponsors both a 401(a) and a 401(k) plan, contributions to both must be aggregated when applying this limit.

The annual limit on participant elective deferral contributions is the lesser of 100 percent of compensation or \$16,500 for 2009 (indexed for inflation thereafter). Participants over age 50 may also make "catch-up" contributions up to \$5,500 for 2009 (indexed for inflation thereafter).

DB(k)

The Pension Protection Act of 2006 allows for a new DB(k) plan to be offered by employers with up to 500 workers, starting in 2010. DB(k) is a hybrid plan design that will combine a small lifetime pension benefit and a 401(k) with employer matching.

457(b) Deferred Compensation Plans

457(b) deferred compensation plans are available to state and local governments and tax-exempt organizations, except churches or church controlled organizations. They are not available to for-profit employers.

403(b) Plans

403(b) plans are available to public education employers, church employers and 501(c)(3) tax-exempt organizations. They are not available to for-profit employers.

SEP-IRA

SEP-IRAs are open to all employers with one or more employees. A written plan document is required. Contribution limits are higher than other IRAs, but employee contributions are not allowed.

Annual employer contributions are not mandatory—employers may decide each year whether to contribute. For a SEP discretionary contribution to remain excludable from an employee's compensation, the contribution is limited to the lesser of: (1) 25 percent of includible compensation (less any contribution made under a section 125 arrangement), or (2) the 415 limit (\$49,000 for 2009 indexed for inflation in \$1,000 increments thereafter). Contributions must be allocated to participants based on the plan's written allocation formula. The employer must provide to each participant a copy of the plan document (5305-SEP), a statement regarding investment rates of return, a copy of amendments within 30 days of its effective date, and timely, written notification regarding employer contributions to the plan.

SIMPLE IRA

These plans are available to all employers with 100 or fewer employees who earned \$5,000 or more in compensation during the preceding calendar year.

The employer may not sponsor a Simple IRA if currently maintaining another retirement plan. Employee contributions are voluntary and pre-taxed, as in a 401(k). Employer contributions are mandatory.

Contributions are subject to limits:

- (1) Elective employee deferral contributions are limited to the lesser of \$11,500 for 2009 (indexed for inflation in \$500 increments) or 100 percent of compensation for the calendar year.
- (2) Mandatory employer contributions are limited to either a:
 - a) One-hundred percent matching contribution equal to each participant's elective deferral contribution up to a limit of three percent of compensation; or
 - b) Non-elective contribution equal to two percent of each participant's compensation for each participant who earns more than \$5,000.

Voluntary IRA

Voluntary IRAs are individual retirement accounts set up by individuals with no involvement from the employer.

The annual contribution limit is \$5,000 for 2009, indexed for inflation in future years. People age 50 or over may contribute an additional \$1,000 annually.

IRAs can take the form of a traditional IRA (the original IRA form) or a Roth IRA (a newer form introduced in 2001 under EGTRRA). The main difference is the tax treatment of contributions and

distributions, discussed below.

Traditional IRA

Contributions to a traditional IRA may be tax deductible. Assets accumulate tax free while in the IRA. When distributed, the assets become taxable.

The tax deductible amount of the contribution is gradually reduced to zero for higher compensated individuals. The limits depend on the person's tax filing status and income level.

Distributions before age 59½ may be subject to a 10 percent early withdrawal penalty.

Minimum distributions must begin by age 70½.

Roth IRA

Contributions to Roth IRAs are subject to income tax in the year of contribution rather than the year of distribution. This may be advantageous to people who expect to have a higher tax rate later in life.

Nevertheless, Roth IRAs enjoy the same tax-free accumulation of assets as traditional IRAs. There is also no requirement to take distributions at age 70½.

Payroll Deduction IRA

Payroll deduction IRAs are voluntary IRAs that individuals fund using contributions that the employer deducts directly from their pay and deposits to the IRA. They can be classified as traditional or Roth IRAs and are open to all employers with one or more employees.

Section Four – Proposals

The financial industry offers a wide array of workplace retirement plans developed for all levels of customers. Even so, research from EBRI finds that up to 50 percent nationally and 40 percent of Washington workers are not covered by a workplace plan.²² Further, most research shows that there is additional opportunity for providing workplace savings vehicles, and little dispute that they are useful and beneficial. Opinions on how to create the expansion differ.

The Department developed proposals based on these conclusions to meet the goal of penetrating a market that has proven difficult for the private sector to penetrate – small businesses or businesses with a more mobile workforce.

We developed three options for consideration by the Legislature based upon research with legal counsel, university based experts in finance and retirement, independent research organizations, and EOI. The proposals were reviewed and discussed with other governments, other interested advocacy organizations, retirement professionals, financial institutions, financial institution associations, and investment professionals. We have also included representative feedback about each proposal from our review process.

These proposals attempt to impact, not solve the problem. The market we hope to impact is individuals who can be persuaded to save for retirement within their means.

Our proposals, particularly Option 1 and Option 2, are based on the concept that savings vehicles exist, but the market needs to be simplified. In other words, persuading people to save for retirement with simple, easy-to-access vehicles in their workplace is a valuable role for government. Option 3 combines the persuasion role of government with a more direct sponsorship role.

Option 1 – Inflation Protected Payroll Deduction or Individual IRA

The state will create the specifications for a payroll deduction or individual IRA. The opportunity for payroll deduction requires less initiative for the employee, utilizing the power of payroll deduction to facilitate savings. There may also be flexibility in the future to provide automatic enrollment to further promote saving. Any financial institution that is qualified to offer IRAs in the State of Washington could offer this generic product using the state's name if the product met the required specifications. The fees charged to participants would conform to standards determined by the state, so all organizations offering the IRA will provide the same fee structure.

Two features distinguish this IRA. First, in the interest of simplification, there is no choice of how the money will be invested. Second, the return required would be the same as Treasury Inflation-Protected Securities (TIPS) whether or not the underlying assets are invested in TIPS. Conversely, the underlying asset could be required to be TIPS to avoid the possibility of losses similar to those seen in the markets in 2008.

The state, through the Department of Retirement Systems or any agency the Legislature designates, would provide the marketing for this generic product. The financial institution or vendor would provide

²² See Attachment 2 – Employer plan sponsorship and participation rates, U.S. and Washington State.

administrative, investment and customer interface services.

Marketing will be media and Web based. Financial institutions offering the state's brand name product would need to demonstrate compliance with the specifications. Upon doing so, the designated government agency would include their name in a dedicated Internet link promoting the plan.

Media based marketing will be directed at saving and safe investing, not retirement education. The goal is to create a new market of savers who will gradually become more sophisticated at saving for retirement and access existing education which is readily available and prolific. The message will be designed to persuade individuals to invest some portion of their savings that they cannot afford to lose in safer investments. The message could be rephrased, for example, from a generic "save for your retirement," which may be overwhelming for many people, to something more goal oriented that people can envision or relate to. Possible messages could be crafted to focus on basic needs like saving for food or housing.

Marketing costs can be anticipated to approximate the Washington State Guaranteed Education Tuition (GET) program costs of \$650,000 to \$750,000 per year. These costs can be borne by the state as a social service or economic development program, and/or shared by participating vendors or program participants.

These plans could be offered as either traditional or Roth IRAs. Roth IRAs may provide an advantage for moderate or lower income households who are in a low tax rate and may not get much benefit from the deferred taxes on contributions to a traditional IRA. They may recognize greater savings from tax-free distributions from the Roth IRA in the future, especially if their income or tax bracket increases over time.

These plans can be either employer sponsored as payroll deduction IRAs or set up by individuals as individual IRAs.

Advantages

- This option provides the opportunity for an innovative public/private partnership that promotes the value of saving.
- It promotes simple but effective basic saving principles, challenging the assumption (encouraged by the bull market of the last twenty years) that market growth is the only answer to retirement savings.
- It is a simple program for employees and employers to comprehend. It removes some of the complexity for the individual who is new to and wants to get started on saving for retirement.
- It avoids some of the complexity, cost and time constraints that discourage small employers from establishing workplace savings plans.
- It leverages existing IRS approved plans.
- It is portable for individuals and has the potential to be portable between employers with cooperation from financial institutions and vendors.
- It may limit the state's potential liability (see Section 5).

- Marketing costs could be borne by the state, private sector or plan participants through fees.
- Administrative and investment functions are performed by the private sector.
- Fees will conform with standards determined by the state, so all organizations offering the IRA will provide the same fee structure. Fees will be negotiated using industry standard costs for providing similar financial services.
- It potentially creates a new market of savers for financial institutions and vendors who can mature into other products.
- Financial institutions and vendors may be able to focus their previous efforts on this program and enhance marketing to this target audience.
- Payroll deduction can facilitate easier and automatic employee savings.

Disadvantages

- Little ability exists to test this product except through implementation. Negative experience by financial institutions and vendors trying to penetrate the small business or business with a mobile workforce is the best evidence, coupled with studies and projections of inadequate savings for retirement in the targeted segment of the population.
- Employers who do not offer plans and those lower and middle income and mobile workers are the target market because they have been less able to save for retirement at their workplace. This program is designed to be part of the solution, not the only solution, on the basis that starting is better than not progressing at all.
- Contributions are subject to normal IRA limits. These limits, however, are anticipated to be sufficient to meet the target market's need and demand for savings.
- Balances are likely to be low, increasing administrative costs. This is offset by the elimination of investment choice and by other efficiencies which lower administrative costs.

Stakeholder Comment

This option receives positive comments from nearly all stakeholders, represented by the following summary points:

- Access to a plan at work and starting to save are the missing elements in retirement preparation. Excellent education exists for those who want it or know how to access it.
- This option provides an easy, well supported opportunity to help some people save for retirement.
- It is a positive role for the government to support increased retirement savings.
- It is innovative and effective in its simplicity.
- If it is simple, people will sign up. Simplicity supports the level and degree of comprehension by employees and employers needed to have rapid and significant participation by both.
- This option provides motivation to the private sector to create offerings consistent with the

requirements and goals of WVA.

- The uniformity of design among vendors will have a positive impact on market penetration.
- Marketing will be challenging. Tying the value of retirement savings to annuities will improve the marketing success.
- It recognizes a market need, fills it, and is a move in the right direction.
- Government can play an effective role in simplifying the market supply for low-cost employer provided retirement plans with this option.

Option 2 – Growth and Inflation Protected Payroll Deduction or Individual IRA

This option is similar to Option 1 except that the underlying investments are more complex and would be designed to combine stability with the opportunity for better returns during good economic times. Although the investment structure for this option is still conceptual, the goal is to have a combination of inflation protected and growth products that would return at least the principal investment if held to maturity. For example, the investment could be a balanced portfolio that consists mostly of principal preservation type assets (e.g., bonds) with a small amount of equities. The bonds guarantee that, at a minimum, an investor will receive every dollar invested back at its future value, and the stocks offer opportunity for some growth. This option is designed to encourage regular, long-term investing.

Advantages

- This option provides the opportunity for an innovative public/private partnership that promotes the value of saving.
- It is a simple program for employees and employers to comprehend. It removes some of the complexity for the individual who is new to and wants to get started on saving for retirement.
- It avoids some of the complexity, cost and time constraints that discourage small employers from establishing workplace savings plans.
- It leverages existing IRS approved plans.
- It is portable for individuals and has the potential to be portable between employers with cooperation from financial institutions and vendors.
- It may limit the state's potential liability (see Section 5).
- Marketing costs could be borne by the state, private sector or plan participants through fees.
- Administrative and investment functions could be performed by either the private or public sector.
- Fees will conform to standards determined by the state, so all organizations offering the IRA will provide the same fee structure. Fees will be negotiated using industry standard costs for providing similar financial services.
- It potentially creates a new market of savers for financial institutions and vendors. These new savers can mature into other products.

- Financial institutions and vendors may be able to focus their previous efforts on this program and enhance marketing to this target audience.
- Payroll deduction can facilitate easier and automatic employee savings.

Disadvantages

- Little ability exists to test this product except through implementation. This option is similar to existing target date or life cycle products with which financial institutions and vendors have been unsuccessful in penetrating this market.
- Employers who do not offer plans and those lower and middle income and mobile workers are the target market because they have been less able to save for retirement. This program is designed to be part of the solution, not the only solution, on the basis that starting is better than not progressing at all.
- This program is more complex and expensive to administer, both for the financial institution or vendor and for the state because it is multi-year and contains an equity component. It is more difficult to create uniform returns because of the equity component. It is likely that the state would have to contract for the equity or growth portion to ensure uniform returns. This increases the complexity of record keeping and interacting with financial institutions or vendors for contributions, withdrawals and distributions. It is more complex for financial institutions and vendor record keeping.
- Contributions are subject to normal IRA limits. These limits, however, are anticipated to be sufficient to meet the target market's need and demand for savings.
- Balances are likely to be low, increasing administrative costs. This is offset by the elimination of investment choice and by other efficiencies which lower administrative costs.

Stakeholder Comment

This option receives similar positive comments to Option 1, with the exception of the following reservations:

- This program is more complex to administer than a single asset product.
- The product requires more investor sophistication.
- It caps the downside but offers growth on the upside which may improve the adequacy of the benefit achieved through this option.
- It will be higher cost than Option 1.

Option 3 – State Administered 401(k)

The state will create a prototype 401(k) plan that private sector employers could adopt. Employees of the sponsoring employers could voluntarily defer a portion of their pay to the plan. The plan will also allow each sponsoring employer to determine whether or not to provide matching contributions.

The state will design the basic features of the plan and contract with third-party vendors for

administration. The prototype 401(k) will be a single-employer plan, which means there will be a separate plan and trust for each employer that chooses to participate.

Each sponsoring employer will select from a menu of limited plan design options. Some employer decisions may involve whether or not to automatically enroll employees, frequency and timing of new enrollments, and whether or not to match contributions and the type and size of employer match.

A unique, limited selection of investment funds will be made available through the prototype 401(k) plan. These options will include cash, bond and equity components as determined by the Washington State Investment Board. Participants will determine which fund their contributions will be directed to, and may change that designation for future contributions. Participants may also make fund-to-fund transfers within their own accounts.

Federal laws and regulations contained in the Internal Revenue Code and the Employee Retirement Income Security Act (ERISA) provide detailed specifications for tax-qualified 401(k) plans. A written plan document is required. Prior to implementation, the state will request approval of a master plan or prototype and adoption agreement from the IRS. Individual employers will utilize the adoption agreement to make their limited plan design selections. Each employer will be required to adhere to the various regulatory requirements, including annual discrimination testing, if applicable to the plan.

In addition to obtaining federal approvals and contracting with third-party vendors for administration, the state will determine investments, provide oversight and market the program.

The state will market the plan to private sector employers who don't currently offer a workplace retirement program to their employees. Marketing efforts may include public service announcements, direct mailings to employers and information that will be made available on a state Web site. Materials will also be provided to help employers communicate the plan features and enrollment process to their employees.

The third party administrator will manage participants' accounts, provide direct customer service and Web-based account access, and distribute account statements, newsletters and other plan communications.

Advantages

- This option provides the opportunity for small private sector businesses to participate in a large institutional fund, receiving the benefits of the Washington State Investment Board's investment expertise and ability to leverage a favorable investment fee structure and the Washington State Department of Retirement System's efficiencies and administrative capabilities.
- This option allows for higher contribution limits than IRAs, and permits matching employer contributions which could encourage employee savings.
- It provides more plan design flexibility, allowing the state to choose features, such as auto-enrollment, that may support savings goals.
- Record keeping could be outsourced to a private sector service provider.

Disadvantages

- Employees would only have the option to participate if the employer chooses to start a plan.
- Although this option could potentially reduce employers' costs in terms of fees and testing, the state cannot impact an employer's interest or ability to make contributions. When offered, employer contributions significantly improve participation in a 401(k) plan.
- As a practical matter 401(k) plans require a minimum of three investment choices, increasing the administrative and individual member complexity.
- This plan is much more complex, requiring participating employers and employees to make several investment-related and financial decisions.
- It requires more responsibility, expense and time for participating employers.
- It increases liability/risk for the state and employers (see Section 5).
- This is the most expensive option for employers, employees and the state.
- This option would likely reduce private sector participation by limiting the number of financial providers that would provide administration for the program.
- It would require IRS approval prior to implementation and is subject to various federal requirements, such as annual testing, reporting, and audits.
- Mobile workers would need to open a separate account with each sponsoring employer to participate in that employer's plan. Funds can be rolled into a new account, but an account cannot be moved from one employer to another intact.
- Little ability exists to test this product except through implementation. Once implemented, it could be difficult to terminate the plan at the state level.

Stakeholder Comment

A state prototype 401(k) plan prompted divided stakeholder comments.

- Some stakeholders find this a very attractive option. Stakeholders that support this option believe Washington State's existing retirement plan industry operated by the Washington State Investment Board and the Washington State Department of Retirement Systems can provide marketing, access, and low-cost high quality returns and management, increasing penetration to workers wishing to save through their employer.
- Stakeholders that do not find this option attractive believe this is not an appropriate role for state government, since the state would be directly competing with private sector vendors who already feel they offer low-cost products for this market. Others question whether a 401(k) plan best meets the savings needs for the intended market. Some in the financial sector believe this option is too complex and expect that small employers will object to the level of expenses.

Section Five – Legal and Regulatory Challenges and Considerations

In conducting the legal and regulatory review, we relied on numerous sources including research conducted by other states regarding Universal Voluntary Account plans, external tax counsel, the Washington State Attorney General's Office (AGO), and data gathered during the development and preparation of this report.

Since any of the three options may be the first to be implemented by a state government, there are identifiable legal and regulatory challenges that would have to be addressed in the adoption and implementation of a new program. It may not be possible to foresee every potential challenge, nor can every risk be eliminated entirely. Some of the legal considerations and risks will differ depending on which option is selected and final decisions concerning the program design, but many of them apply to the WVA program in general.

Constitutional Considerations

A significant question is whether state involvement as proposed in each option would violate constitutional restrictions such as those that prohibit the gift or loan of state credit to individuals, associations, companies or corporations (Article VIII, section 5) or that prohibit the state from loaning its credit, subscribing to, or being interested in the stock of any company, association, or corporation (Article XII, section 9). In prior claims against the state involving such provisions, courts have found that a program that serves a public purpose that is a fundamental purpose of government is not considered to be a gift or loan of state funds or credit. With the public purpose of helping individuals save for self-sufficiency in retirement, and the fundamental government purpose of reducing the threat of people having to rely on state assistance in the absence of adequate savings, the WVA options described in this report may be judged constitutional. However, no Washington case has considered the constitutionality of a program similar to any of the three options proposed. Therefore, how a court would rule should the program be challenged cannot be predicted with any degree of certainty. In addition, no other jurisdictions have enacted such a program, and thus there is no guidance from courts of other jurisdictions.

Financial Liabilities

Most investments carry some risk of loss. When losses are significant, investors may attempt to recover some or all of the loss from parties with any responsibility, no matter how small or remote. Financial institutions and retirement plan trustees are usually not liable for losses that result from a participant's decision to invest in a particular fund, as long as the institution or trustees acted reasonably and investments were managed solely in the interest of the participants. Of course this would not preclude an individual who suffered a loss from attempting to challenge the institution that provides the investment option or manages the program.

Public/private partnerships as described for Options 1 and 2 would have WVA accounts managed by financial institutions with the experience and infrastructure to do so effectively; but with no direct control over the quality of management of the funds, the state may be seen by the public as a guarantor of last resort should the financial institution fail. With Option 3, while third-party record-keepers may

perform some administrative functions, the state would maintain greater control over the quality of the plan's administration, management and investment of assets. More control and the increased complexity and requirements for 401(k) plans would result in both greater responsibility and exposure to liability for the state.

There are steps the state can take to minimize liability for losses, including contractual provisions, disclaimers, and sound governance practices. Option 1 provides the least investment risk through the use of Treasury Inflation Protected Securities. A good governance structure, with professional and representative board membership and procedural safeguards, could also provide a layer of insulation against liability. It may also be possible to enact specific immunity provisions in state statute. However, if the program is deemed to be subject to Employee Retirement Income Security Act (ERISA) or other federal statutes in whole or in part, those federal statutes may preempt state law and preclude state immunity.

Additionally, contracts with financial vendors may include indemnification requirements. Marketing materials, advertisements and enrollment forms could include disclaimers of state liability for losses. Fiduciary insurance might also protect the state against judgments that could arise from successful claims. However, the extent to which courts would enforce such disclaimers depends on factors such as the clarity of the language used, the degree of attention drawn to the language, other written or verbal statements made to the participants, and other factors.

Regulatory Compliance

The Internal Revenue Service (IRS) establishes regulations that cover individual and employer retirement plans, and the Federal Department of Labor (DOL) regulates private-sector employer plans under the ERISA. Since the WVA program could include both individual and employer participation, all of these regulations must be considered. Individual Retirement Accounts (IRA) are not typically subject to ERISA requirements, so Options 1 and 2 would have fewer regulatory hurdles than the 401(k) plan described in Option 3. Payroll Deduction IRAs, however, only retain their exemption from ERISA's pension plan requirements if the employer complies with DOL's interpretation of the exemption provisions, which includes maintaining neutrality so as not to be considered to be "endorsing" the product, and not exerting any influence over the investments permitted by the IRA sponsor.²³ If the state establishes one or more investment funds, they would also need to be registered with the Securities and Exchange Commission (SEC).

Federal violations could result in financial penalties. These regulatory risks would require the state to work closely with tax counsel and federal regulators to minimize liability and ensure compliance, as well as to protect the ongoing government status of the existing state retirement plans.

²³ See 29 C.F.R. § 2509.99-1 (also known as Interpretive Bulletin 99-1).

Section Six – Next Steps

The Department conducted this study and developed the program options in the period leading up to and during the most volatile financial markets of our times. We began this project when values in the stock market were at an all-time high and have seen them drop nearly 45 percent, spurring speculation of a clear recession and possibly a depression. We witnessed unprecedented disruption and business dissolution in the financial sector. The outcome of these events on the financial sector and the economy is unclear because they are as yet unresolved with no imminent resolution in sight.

These events in many ways made the development of this report easier as credible research institutions and interested groups began to publish data on a problem that was speculative when we began, but has taken shape at the end of our effort. We as a nation have also experienced a significant change in sentiment expressed in the outcome of the 2008 presidential and national election prior to the submission of this report to the Legislature. The new president views this as a pressing issue and has expressed ideas about how the federal government can become involved.

Our work was ultimately conducted simultaneously with other efforts to address the same problem Washington State is facing. Other state governments stepped out during this time period and we were able to learn from their experience. Finally, we were open to all perspectives on the issue of people saving for retirement and can say it is an issue everyone is concerned about – governments, private sector employers, employees and future retirees, labor organizations, associations and the financial industry.

Our initial approach was to present three options for the consideration of the Legislature. Given the current economic conditions and change in national elections, we recommend that the Washington State Legislature direct the Department to pursue the development of Option 1 – a public/private partnership with financial vendors based on no choice investment payroll deduction or individual IRAs as a starting point.

Our reasoning is based on several factors. First, we have received a positive response to this approach from all stakeholders. It is relatively easy, low-cost and innovative. It enables the state to assist but not compete with private sector savings through its most valuable asset – its impartial voice and concern for citizens. Second, we believe this option is a sound approach to basic saving for retirement, especially if employers offer payroll deduction IRAs. Third, we believe our approach can serve as a model for other states. And fourth, it is similar in concept to the automatic IRA proposal endorsed by President-Elect Obama. Washington can either develop its proposal in concert with the federal proposal, defer to the federal proposal if it is successfully adopted, or pursue the proposal independently if it appears that the federal effort will be discontinued or sufficiently delayed.

The environmental factors mentioned in this section serve as an inhibitor to the submission of a final proposed solution to the Legislature. However, through the Department's work with stakeholders in the financial services industry, it appears that a public/private partnership approach could represent the interest of the state while using existing services provided by private financial institutions.

The strength of this proposal is that it allows the state to promote retirement savings while creating a positive synergy between the public and private sectors. We believe from our efforts that there is

interest on the part of financial institutions to offer the recommended products, but ultimately only experience will show whether there is actual interest. The report was developed during extreme market volatility. The recommendations reflect the changing needs of individuals and employers made clearer by the experience over the last 18 months.

Attachment 1 – Substitute House Bill 1128 (Chapter 522, Laws of 2007), Sec. 135

(8) \$200,000 of the general fund – state appropriation for fiscal year 2008 and \$250,000 of the general fund – state appropriation for fiscal year 2009²⁴ are provided solely to design a plan for the operation of a universal voluntary retirement accounts program, and then seek approval from the federal internal revenue service to offer the plan to workers and employers in Washington on a tax qualified basis. Features of Washington voluntary retirement accounts plan include a defined contribution plan with a limited pre-selected menu of investment options, administration by the department of retirement systems, investment oversight by the state investment board, tax-deferred payroll deductions, retirement account portability between jobs, and a two-tier system with workplace based individual retirement accounts open to all workers, and a deferred compensation 401(k)-type program or SIMPLE IRA-type program open to all employers who choose to participate for their employees. As part of this process, the director shall consult with the department of financial institutions, the state investment board, private sector retirement plan administrators and providers and other relevant sectors of the financial services industry, organizations promoting increased economic opportunities for individuals, employers, workers, and any other individuals or entities that the director determines relevant to the development of an effective and efficient method for implementing and operating the program. As part of this process, the director shall evaluate the most efficient methods for providing this service and ways to avoid competition with existing private sector vehicles. The director shall undertake the legal and development work to determine how to implement a universal voluntary retirement accounts program, managed through the department of retirement systems directly or by contract. By December 1, 2008, the director shall report to the Legislature on the program's design and any required changes to state law that are necessary to implement the program.

²⁴ The FY 09 amount was reduced by \$123,758 to help the state address declining revenue caused by the continuing national economic crisis.

Attachment 2 – Employer plan sponsorship and participation rates: U.S. and Washington State

Percentage of Various Work Forces Who Work for an Employer That Sponsored a Retirement Plan, and the Percentage Who Participated in a Plan, United States Versus the State of Washington, 2004-2006

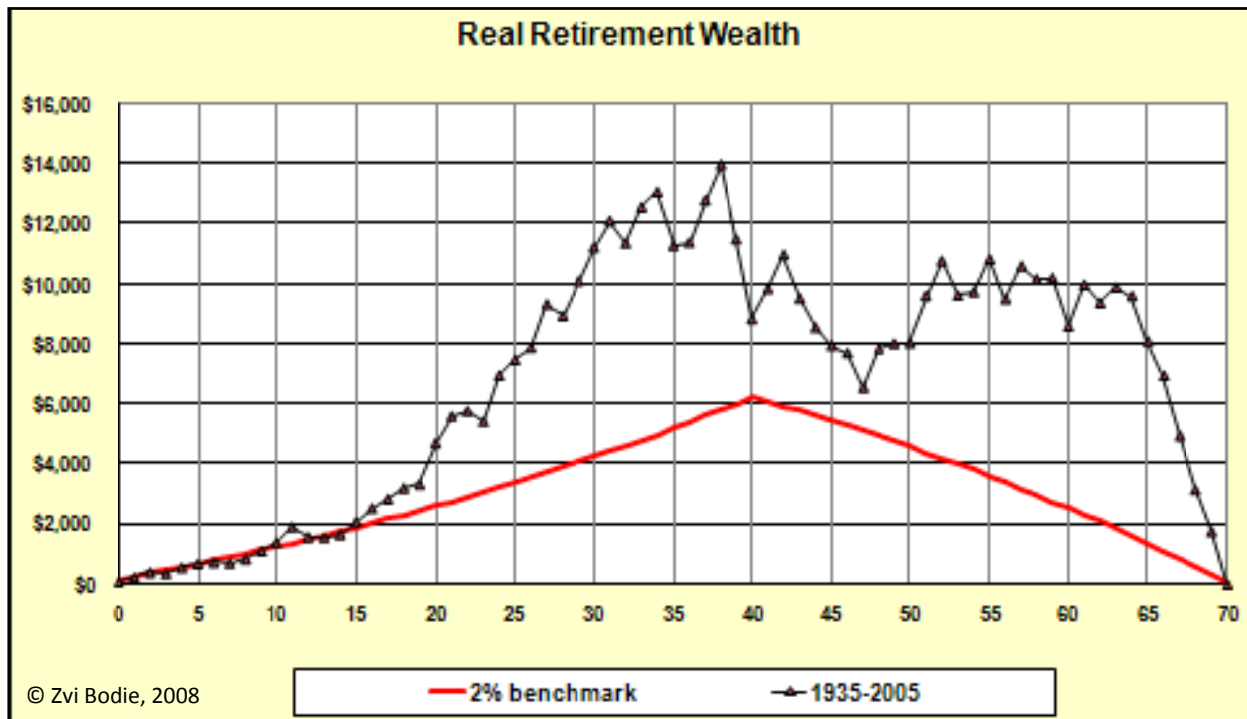
| | Wage and Salary Workers Ages 21–64 | | Private Wage and Salary Workers Ages 21–64 | | Public Wage and Salary Workers Ages 21–64 | | Full-Time, Full-Year Wage and Salary Workers Ages 21–64 | | | |
|-------------------------|---------------------------------------|------------|---|------------|--|------------|--|------------|--------|--------|
| | U.S. | Washington | U.S. | Washington | U.S. | Washington | U.S. | Washington | | |
| Worker Category Total | 154.83 | 3.45 | 128.33 | 2.85 | 107.78 | 2.37 | 20.55 | 0.48 | 94.04 | 1.91 |
| Works for an Employer | | | | | (millions) | | | | | |
| Sponsoring a Plan | 79.78 | 1.96 | 73.77 | 1.81 | 56.61 | 1.39 | 17.16 | 0.41 | 59.03 | 1.35 |
| Participating in a Plan | 63.16 | 1.49 | 60.22 | 1.43 | 44.88 | 1.08 | 15.33 | 0.36 | 51.41 | 1.15 |
| Worker Category Total | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |
| Works for an Employer | | | | | (percentage) | | | | | |
| Sponsoring a Plan | 51.5 | 56.8 | 57.5 | 63.5 | 52.5 | 58.9 | 83.5 | 86.5 | 62.8 | 70.7 |
| Participating in a Plan | 40.8 | 43.3 | 46.9 | 50.3 | 41.6 | 45.4 | 74.6 | 74.5 | 54.7 | 60.3 |

Source: Employee Benefit Research Institute estimates from the 2005-2007 March Current Population Survey.

Attachment 3 – Simulations of Risk Free and Target Date Funds

Zvi Bodie, finance professor at Boston University School of Management, an expert on retirement security and co-author of the leading finance textbook *Investments*, compares a risk free investment to a typical target date fund growth investment.

The model assumes a 40 year working career with contributions of 100 units per year, and a 30 year retirement payout period.

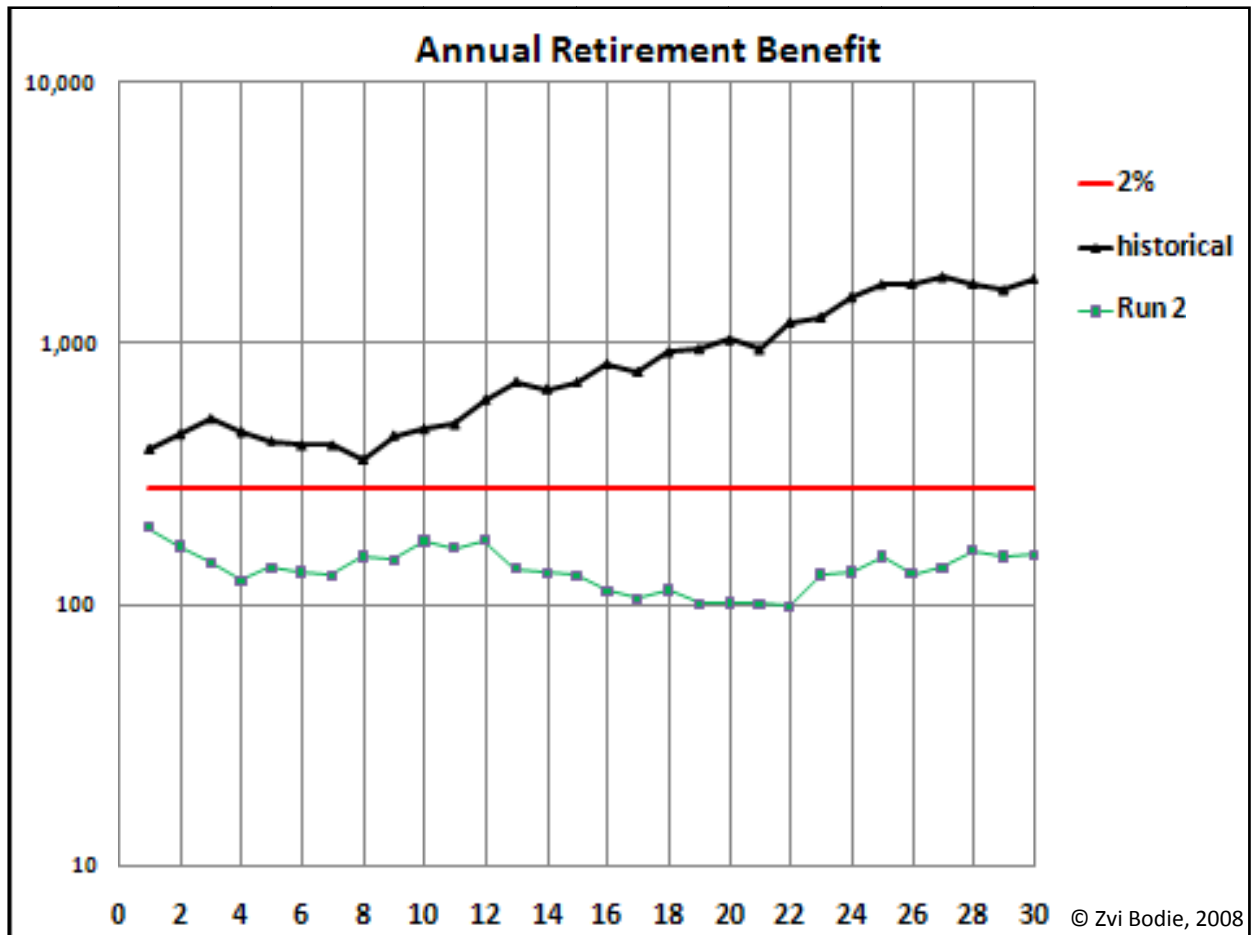


The retirement wealth graph contrasts the modeled growth investment using the actual 70 year historical performance from 1935-2005 with the modeled risk-free 2 percent real return benchmark.

The historical performance uses a typical target date fund (TDF) asset mix, initially 90 percent stocks and 10 percent bonds and adjusted each year by 1 percent until it is 50 percent stocks and 50 percent bonds at the target retirement date (at the end of year 40). The asset mix remains at 50 percent stocks and 50 percent bonds throughout the 30 year retirement benefit phase.²⁵

The risk-free 2 percent benchmark model assumes an inflation linked bond fund with a real rate of return of 2 percent above inflation. Under this assumption, the risk free investment would provide a real income of 280 units per year for the 30 year retirement payout period.

²⁵ The model uses the actual distribution of real annual returns for the years 1926-2005 to do random bootstrap Monte Carlo simulations of the accumulation and decumulation of retirement savings over the 70 year period. During the 30 year retirement benefit phase, benefit withdrawals are patterned after a variable annuity with an assumed interest rate (AIR) of 2 percent.



The retirement benefits graph shows the historical growth investment scenario, the risk free benchmark scenario, and another simulated target date fund scenario (Run 2). The historical growth investment and the Run 2 growth simulation both use the target date fund asset mix described above.

The model simulations show that even though the growth outcomes can be better than the risk free outcome, there are also potential outcomes that can be worse, even after a long 70 year time horizon.

Attachment 4 – Proposal Details

Option 1 – Inflation Protected Payroll Deduction or Individual IRA

| Option 1 - Inflation Protected Payroll Deduction or Individual IRA | |
|--|--|
| Description | <p>With this option, the state will create a framework for Individual Retirement Accounts (IRAs) that can be offered by financial institutions throughout Washington. The IRA will incorporate features that make establishing and contributing to a retirement plan easier for current non-savers. These features include easy access through existing financial service providers, a simple process to open the account, low fees and a single choice investment fund that is safe and keeps up with inflation and contributions through payroll deductions.</p> <p>The state will establish the plan’s specifications and help market the program. Any financial institution that is qualified to offer IRAs in Washington may choose to offer the plan to new or existing customers.</p> |
| Plan Type | <p>This IRA will be structured as an Individual Retirement Account and comply with federal laws and regulations. Individuals can contribute to the IRA through a payroll deduction, if their employer provides this option. Otherwise, contributions can be made to the IRA directly by the individual. Both a traditional IRA (IRC Sec. 408) and a Roth IRA (IRC Sec. 408A) will be offered.</p> |
| Administration | <p>These IRAs will be administered by the financial institutions using the state’s plan design. The state will provide oversight of the program.</p> |
| Eligibility | <p>All workers within the state of Washington will be eligible to participate as long as they meet federal requirements for the type of IRA they have selected. For example, someone who is 70-½ or older would not be eligible to contribute to a Traditional IRA, but could contribute to a Roth IRA.</p> <p>Any financial institution that is qualified to offer IRAs in the state of Washington can offer the IRA to new or existing customers, as long as it conforms to the plan specifications established by the state.</p> |
| Employee Contributions | <p>Annual contribution limits are established by the federal government. Workers may contribute up to 100 percent of their total wages for the year or the annual limit, whichever is less. For 2009, the annual limit for IRA contributions is \$5,000. Workers age 50 and older may contribute up to \$6,000 if they earned at least that much in wages. In addition, there are certain income limits for individuals contributing to an IRA.</p> |
| Employer Contributions | <p>Employer contributions are not permitted.</p> |
| Tax Implications | <p>For a traditional IRA, contributions may be tax deductible which reduces the worker’s tax basis for that tax year. When distributed, the assets become taxable.</p> |

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| | <p>For a Roth IRA, contributions are post tax money and no taxes have to be paid under normal distributions.</p> <p>The worker can choose whether to pay taxes up front with a Roth IRA, or when the funds are withdrawn with a Traditional IRA.</p> |
| Withdrawals and Distributions | <p>Withdrawals and distributions are governed by the federal laws and regulations covering all IRA plans. In general, contributions to an IRA can be withdrawn at any time. Withdrawals made before the participant reaches age 59-½ may be subject to an additional 10 percent early withdrawal tax.</p> <p>Participants of a Traditional IRA will be required to begin taking withdrawals no later than April in the year following the year in which they turn age 70-½.</p> |
| Rollovers | <p>Funds can be rolled over to 401(a), 401(k), 403(a), governmental 457(b), 403(b) plans or to another IRA.</p> |
| Investments | <p>The single investment product will provide inflation protected returns (such as TIPS).</p> |
| Regulatory Requirements | <p>Financial institutions will be responsible for governmental reporting, which includes distributions on Form 1099-R and fair market value on Form 5498.</p> <p>Non-payroll deduction IRAs are not subject to ERISA requirements. Therefore, a plan document, IRS approval or discrimination testing are not required.</p> |
| Fees | <p>Fees will conform to standards determined by the state, so all organizations offering the IRA will provide the same fee structure. Fees will be negotiated using benchmark information obtained from financial services institutions as the starting point.</p> |
| Marketing | <p>The state will market the IRA to individuals. Marketing efforts may include public service announcements and information that will be made available on a state Web site. Materials will also be developed that explain the plan and enrollment process.</p> <p>The marketing program may focus on saving for a specific necessity, such as food or housing after one has retired, providing a realistic savings goal for the target market.</p> <p>Financial institutions can also market that they offer the state IRA.</p> |
| Roles | |
| Employer | <ul style="list-style-type: none"> • Decide whether or not to offer payroll deductions. • Provide employee with information about payroll deduction IRA and payroll form authorizing employer to withhold amounts from pay check. • Establish payroll deduction IRA with one or more financial institutions. |

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| | <ul style="list-style-type: none"> • Withhold amounts requested by employees. • Promptly deposit withheld amounts to employees’ IRAs. <p>Although payroll deduction IRAs are not typically subject to ERISA rules, employers could have certain responsibilities if they implement a payroll deduction IRA, e.g. timely remittance of contributions to financial institutions.</p> <p>Employers who do not remain neutral, and promote a particular product such as a state IRA, could be subject to ERISA requirements.</p> |
| Employee | <ul style="list-style-type: none"> • Establish a Traditional or Roth IRA with financial institution. • Determine amount to contribute to IRA, based on applicable contribution limits. • Authorize payroll deduction if employer offers payroll deduction IRA. |
| Financial Institution | <ul style="list-style-type: none"> • Agree to offer an IRA that conforms to the state specification. • Receive, invest and manage funds. • Provide statements to participants. • Provide governmental reporting for distributions. • Notify participants of minimum distributions. • Pay benefits when requested. • Provide IRA data to the state for monitoring program effectiveness. |
| State | <ul style="list-style-type: none"> • Develop specifications for IRA. • Establish investment criteria. • Provide marketing and education. • Contract with financial institutions. • Provide general oversight and evaluate program’s effectiveness. |
| Costs/Fees | |
| Employer Fees | Employers would be responsible for the costs associated with setting up their payroll systems to deduct/submit contributions to the financial institution(s). |
| Employee Fees | Participants will pay a fee to the financial institution for maintaining their IRAs. Although the exact fees are unknown at this time, it is estimated that the annual fee will be assessed as a flat amount ranging from \$20-\$60 for administration and 0.02 percent of the participant’s IRA account value for investment management. Details of these estimates and the underlying assumptions used are provided separately. |
| Financial Institutions | Financial institutions already have the infrastructure necessary for administering the state IRA. The fees paid by the participants will cover the basic expenses associated with managing these accounts and a minimal profit margin for the financial institutions. |
| State | The state will fund one-time program set up costs, as well as costs for marketing and education, and contract management. Start-up costs: \$1.9 million over two years On-going costs: \$1.4 million per year |

Option 2 – Growth and Inflation Protected Payroll Deduction or Individual IRA

| Option 2 – Growth and Inflation Protected Payroll Deduction or Individual IRA | |
|---|--|
| Description | <p>With this option, the state will create a framework for Individual Retirement Accounts (IRAs) that can be offered by financial institutions throughout Washington. Similar to Option 1, this IRA will simplify saving and investing for workers who don't have the time or desire to become expert investors. These features include easy access through existing financial service providers, a simple process to open an account, reasonable fees and a single choice investment fund that is safe and keeps up with inflation with some growth potential, and contributions through payroll deductions.</p> <p>The state will establish the plan's basic parameters and help market the program. Any financial institution that is qualified to offer IRAs in the state of Washington may choose to offer the plan to new or existing customers.</p> |
| Plan Type | <p>The IRA will be structured as an Individual Retirement Account and comply with federal laws and regulations. Individuals can contribute to the IRA through a payroll deduction, if their employer provides this option. Otherwise, contributions can be made to the IRA directly by the individual. Both a traditional IRA (IRC Sec. 408) and a Roth IRA (IRC Sec. 408A) will be offered.</p> |
| Administration | <p>The IRAs will be administered by the financial institutions using the state's plan design. The state will provide oversight of the program.</p> |
| Eligibility | <p>All workers within the state of Washington will be eligible to participate as long as they meet federal requirements for the type of IRA they have selected. For example, someone who is age 70-½ or older would not be eligible to contribute to a Traditional IRA, but could contribute to a Roth IRA.</p> <p>Any financial institution that is qualified to offer an IRA in the state of Washington can offer the state IRA to new or existing customers, as long as it conforms to the plan specifications established by the state.</p> |
| Employee Contributions | <p>Annual contribution limits are established by the federal government. Workers may contribute up to 100 percent of their total wages for the year, or the annual limit, whichever is less. For 2009, the annual limit for IRA contributions is \$5,000. Workers age 50 and older may contribute up to \$6,000 if they earned at least that much in wages. In addition, there are certain income limits for individuals contributing to an IRA.</p> |
| Employer Contributions | <p>Employer contributions are not permitted.</p> |
| Tax Implications | <p>For a traditional IRA, contributions may be tax deductible which reduces the worker's tax basis for that tax year. When distributed, the assets become taxable.</p> <p>For a Roth IRA, contributions are post tax money and no taxes have to be</p> |

| | |
|---|--|
| | <p>paid under normal distributions.</p> <p>The worker can choose whether to pay taxes up front with a Roth IRA, or when the funds are withdrawn with a Traditional IRA.</p> |
| <p>Withdrawals and Distributions</p> | <p>Withdrawals and distributions are governed by the federal laws and regulations covering all IRA plans. In general, contributions to an IRA can be withdrawn at any time. Withdrawals made before the participant reaches age 59 ½ may be subject to an additional 10 percent early withdrawal tax.</p> <p>Participants of a traditional IRA will be required to begin taking withdrawals no later than April in the year following the year in which they turn age 70-½.</p> |
| <p>Rollovers</p> | <p>Funds can be rolled over to 401(a), 401(k), 403(a), governmental 457(b), 403(b) plans or to another IRA.</p> |
| <p>Investments</p> | <p>A single investment product that will provide inflation protection with some potential for growth. Although the investment structure for this option is still conceptual, the goal is to have a combination of inflation protected and growth products that would return at least the principal investment if held to maturity.</p> |
| <p>Regulatory Requirements</p> | <p>Financial institutions will be responsible for governmental reporting, which includes distributions on Form 1099-R and fair market value on Form 5498.</p> <p>Non-payroll deduction IRAs are not subject to ERISA requirements. Therefore, a plan document, IRS approval or discrimination testing are not required.</p> |
| <p>Fees</p> | <p>Fees will conform to standards determined by the state, so all organizations offering the IRA will provide the same fee structure. Fees will be negotiated using benchmark information obtained from financial services institutions as the starting point.</p> |
| <p>Marketing</p> | <p>The state will market the IRA. Marketing efforts may include public service announcements and information that will be made available on a state Web site. Materials will also be developed that explain the plan and enrollment process. The goal is to have an easy, one-step enrollment process that would take 15 minutes or less to complete.</p> <p>The marketing program may focus on saving for a specific necessity, such as food or housing after one has retired, providing a realistic savings goal for the target market.</p> <p>Financial institutions can also market that they offer the state IRA.</p> |

| Roles | |
|------------------------------|---|
| Employer | <ul style="list-style-type: none"> • Decide whether or not to offer payroll deductions. • Provide employees with information about payroll deduction IRA and payroll forms authorizing employer to withhold amounts from pay check. • Establish payroll deduction IRA with one or more financial institutions. • Withhold amounts requested by employees. • Promptly deposit withheld amounts to employees’ IRAs. <p>Although payroll deduction IRAs are not typically subject to ERISA rules, employers could have certain responsibilities if they implement a payroll deduction IRA, e.g. timely remittance of contributions to financial institutions.</p> <p>Employers who do not remain neutral, and promote a particular product such as a state IRA, could be subject to ERISA requirements.</p> |
| Employee | <ul style="list-style-type: none"> • Establish a Traditional or Roth IRA with financial institution. • Determine amount to contribute to IRA, based on applicable contribution limits. • Authorize payroll deduction if employer offers payroll deduction IRA. |
| Financial Institution | <ul style="list-style-type: none"> • Agree to offer an IRA that complies with the state specifications. • Receive, invest and manage funds. • Provide statements to participants. • Provide governmental reporting for distributions. • Notify participants of minimum distributions. • Pay benefits when requested. • Provide IRA data to the state for monitoring program’s effectiveness. |
| State | <ul style="list-style-type: none"> • Develop specifications for IRA. • Establish investment criteria. • Provide marketing and education. • Contract with financial institutions. • Provide general oversight and evaluate program’s effectiveness. |
| Costs/Fees | |
| Employer Fees | Employers would be responsible for the costs associated with setting up their payroll systems to deduct/submit contributions to the financial institution(s). |
| Employee Fees | Participants will pay a fee to the financial institution for maintaining their IRA. Although the exact fees are unknown at this time, it is estimated that the annual fee will be assessed as a flat amount ranging from \$20-\$60 for administration and 0.13 percent of the participant’s IRA account value for investment management. Details of these estimates and the underlying assumptions used are provided separately. |

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| Financial Institutions | Financial institutions already have the infrastructure necessary for administering the state IRA. The fees paid by the participants will cover the basic expenses associated with managing these accounts and a minimal profit margin for the financial institutions. |
| State | The state will fund one-time program set up costs, as well as costs for marketing and education, and contract management. Start-up costs: \$2.2 million over two years On-going costs: \$1.5 million per year |

Option 3 – State Administered 401(k)

| Option 3 – State Administered 401(k) | |
|--------------------------------------|---|
| Description | <p>A State Administered 401(k) plan would allow employers to establish retirement plans for their workers. If this option is adopted, the state will create a prototype 401(k) plan that allows employees of sponsoring employers to voluntarily defer a portion of their pay to the plan. The plan will also allow each sponsoring employer to determine whether or not to provide matching contributions.</p> <p>Federal laws and regulations contained in the Internal Revenue Code and the Employee Retirement Income Security Act (ERISA) provide detailed specifications for tax-qualified 401(k) plans. But they also allow some flexibility for employers. The state 401(k) plan will support compliance with applicable federal requirements, while reducing the number of options to simplify plan startup for employers and encourage long-term savings for workers.</p> |
| Plan Type | <p>The state prototype 401(k) will be a single-employer plan, which means there will be a separate plan and trust for each employer that chooses to participate. A single, multiple-employer plan was considered but was determined to be unsuitable due to certain limitations and legal concerns, including shared risk and liability across all participating employers.</p> <p>An unlimited number of employers can offer a state 401(k) plan to their employees. Each sponsor will select from a menu of limited plan design options. Some employer decisions may involve whether to automatically enroll employees, frequency and timing of new enrollments, whether to match contributions and the type and size of employer match.</p> |
| Administration | The plan will be administered by a third party, selected through a competitive bidding process. |
| Eligibility | All workers will be eligible to participate in the plan as long as their employer adopts the plan. |
| Employee Contributions | Employee contributions, also known as participant elective deferrals, may not exceed the federal annual maximum established for 401(k) plans, which is set at \$16,500 for 2009. Workers over age 50 may also make “catch-up” contributions. The “catch-up” contribution limit for 2009 is \$5,500. These maximums may be revised by the federal government each year. |

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| <p>Employer Contributions</p> | <p>Employers may make matching contributions to their employees' accounts. Vesting of matching contributions may vary from immediate 100 percent, to a schedule of gradual vesting over a period of five years, depending on the employer's selection. Total contributions from both the employer and the participant combined may not exceed the federal limit, which is \$49,000 for 2009.</p> |
| <p>Tax Implications</p> | <p>Employers may elect to allow only traditional pre-tax contributions, or they may also offer a Roth alternative that would allow after-tax contributions.</p> <p>For a traditional 401(k), contributions are pre taxed which reduces the worker's tax basis for that tax year. When distributed, the assets become taxable.</p> <p>For a Roth 401(k), contributions are post tax money and no taxes have to be paid under normal distributions.</p> <p>If allowed by the employer, the worker could choose whether to pay taxes up front with a Roth account, or when the funds are withdrawn with a traditional account.</p> |
| <p>Withdrawals and Distributions</p> | <p>Withdrawals and distributions are governed by federal laws and regulations. Withdrawals can generally be made for reasons of termination of employment, disability, death, retirement or hardship. (Roth deferral contributions must also satisfy a five-year participation rule.) If the contributions were originally deducted from taxable income, the withdrawal will be taxable. Withdrawals made before the participant reaches age 59-½ may also be subject to a 10 percent tax penalty.</p> <p>Participants are required to begin taking withdrawals no later than April in the year following the year in which they turn age 70-½, unless the participant is still employed.</p> |
| <p>Rollovers</p> | <p>Funds can be rolled over to IRA, 401(a), 403(a), governmental 457(b), 403(b) plans or to another 401(k).</p> |
| <p>Investments</p> | <p>A limited selection of investment funds will be made available through the state 401(k) plan. These options will include cash, bond and equity components as determined by the Washington State Investment Board. Participants will determine which fund their contributions will be directed to, and may change that designation for future contributions. Participants may also make fund-to-fund transfers within their own account.</p> |
| <p>Regulatory Requirements</p> | <p>The 401(k) is subject to Internal Revenue Code and ERISA requirements. A written plan document is required. Prior to implementation, the state will request approval of a master plan or prototype and adoption agreement from the IRS. Individual employers will use the adoption agreement to make their own limited plan design selections. Each employer will be required to adhere to the various regulatory requirements, including annual discrimination testing, if applicable, to the plan.</p> |

| | |
|----------------------------------|---|
| Fees | Fees will be determined by the state through the Request For Proposal (RFP) process to third-party administrators, and will be based on the cost for administering the program. |
| Marketing | <p>The state will market the plan to employers. Marketing efforts may include public service announcements, direct mailings to employers and information that will be made available on a state Web site. Materials will also be provided to help employers communicate the plan features and enrollment process to their employees.</p> <p>The third-party administrator will manage participants’ accounts, provide direct customer service and Web-based account access, and distribute account statements, newsletters and other plan communications.</p> |
| Roles | |
| Employer | <ul style="list-style-type: none"> • Select plan features from state prototype 401(k) plan document. • Accept terms of participation. • Communicate plan information to employees. • Enroll participants. • Deduct and remit contributions. <p>Although the employer is ultimately responsible for other activities such as distributing benefit statements, annual governmental reporting, and performing fiduciary and trustee compliance reviews, the state will contract with third-party vendors to provide these types of services for all employers participating in the program.</p> |
| Employee | <ul style="list-style-type: none"> • Complete salary reduction and beneficiary forms. • Determine amount to contribute and investment options. |
| Financial Institution | <ul style="list-style-type: none"> • Receive, invest, and manage funds. • Pay benefits and distribute assets as directed by the plan administrator. • Provide annual reports. • Invest assets. |
| Third-Party Administrator | <ul style="list-style-type: none"> • Provide plan documents. • Provide participant communication documents and forms. • Provide call center for participant and employer questions. • Track money and maintain participant accounts. • Provide benefit statements. • Provide distributions and complete 1099s for IRS. • Perform nondiscrimination testing. • Complete 5500 and summary annual report. |
| State | <ul style="list-style-type: none"> • Develop prototype 401(k) plan document and submit to IRS for approval. • Establish investment options. • Provide employer marketing and other related materials for employers to use. |

| | |
|----------------------|--|
| | <ul style="list-style-type: none"> • Contract with third-party vendors for administration of the program, including financial institutions, trustees, administrators, investment managers. • Provide general oversight and evaluate program effectiveness. |
| Costs/Fees | |
| Employer Fees | Employers will be responsible for the costs associated with setting up their payroll systems to deduct/submit the contributions to the financial institution(s). In addition, employers can pay for all or part of the administration fees on behalf of their employees. |
| Employee Fees | Participants will pay a fee to the administrator for maintaining and managing their accounts. Although the exact fees are unknown at this time, we have estimated that the annual administration fees could range from \$200 to \$800 per participant depending on the size of the employer. We believe the investment fees would average 0.40 percent of the participant’s account value. The employer may pay for all or part of the administration fees on behalf of their employees. Details of these estimates and the underlying assumptions used are provided separately. |
| State | <p>The state will fund one-time program set up costs, as well as costs for marketing and education, and contract management.</p> <p>Start-up costs: \$3.4 million over two years</p> <p>On-going costs: \$2 million per year</p> |

Attachment 5 – Fees, Costs and Projections

The fees described in this document are estimates based on research of public information, existing products and private sector service providers. The unique nature of the final WVA program may cause the fees to be higher or lower. The attainment of the estimated fees is dependent on the state's ability to achieve economies of scale and leverage assets during contract negotiations. Actual fees will not be known until the WVA program is implemented and partnerships with the service providers are established.

Fees can generally be grouped into two broad categories; administrative and investment related. Administration fees cover record keeping, communications, customer service, statutory filings, maintaining plan documents, and other legal and fiduciary plan duties. These fees are usually fixed and are expressed as a set dollar amount. Investment fees cover fund management, research and transaction expenses, custodial fees, audit fees and transfer agent fees. These are usually expressed as a percentage of assets in the plan or account. Investment fees may vary depending on the size of the account or plan assets.

The following fee structures best reflect what currently exists in the market. However, the final fee structures may differ from the approaches outlined here. Also, during program implementation, the state will work with stakeholders and partners to establish fees that will encourage participation by first time investors with small account balances.

| Estimated Fees and Costs | Option 1 – Inflation Protected IRA | Option 2 – Growth and Inflation Protected IRA | Option 3 – State-Administered 401(k) |
|------------------------------------|--|---|---|
| Annual Fees Per Participant | | | |
| Administration fees | \$20-\$60 | \$20-\$60 | \$200-\$800 |
| Investment fees | 0.02% | 0.13% | 0.40% |

Administration Fees – IRAs

- IRA administration fees are based on the fee structures of discount brokers and similar financial institutions such as: ING ShareBuilder, TD Ameritrade, E*Trade and Tradeking.
- The administration fee assumes activity volumes ranging from once quarterly to once monthly.
- Assumes full participation will be achieved in six years, with 20,000 participants and \$180 million total contributions.

Administration Fees – 401(k)

- The 401(k) administration fees are assessed by third party administrators (TPAs) based on a survey conducted by Mercer and Associates Inc., and information gathered from TPA Web sites and other research.
- Assumes 15,000 participants and \$56 million investments after six years, with full participation reaching 48,000 participants and \$556 million in contributions at 21 years.
- Assumes the plan administration fee to be about \$3,000. The actual plan fee could range from \$1,000 to \$5,000.
- Assumes the average plan has six participants based on Washington State Employment Security Department information showing the average number of private sector workers per employer (12), and a 50 percent participation rate.

- The actual “per participant” administration fee will be the plan fee divided by the number of participants. Larger employers who have more employees participating in the plan will have lower per participant fees. For example, an employer with 20 employees and 10 participate would result in a \$300 per participant fee ($\$3,000 \div 10$), whereas an employer with 12 employees and 6 participate would result in a \$500 fee.

Investment Fees – Assessed as a Percentage of the Participant's Account

- Option 1 fees assume Treasury Inflation Protected Securities (TIPS) funds.
- Option 2 fees assume TIPS and life-cycle funds.
- Option 3 fees assume life-cycle funds.
- The attainment of the estimated investment fees is highly dependent on the state being able to attain economies of scale and leverage of assets.

Estimated State Costs

| Set-up and implementation (18-24 months) | Option 1 – Inflation Protected IRA | Option 2 – Growth and Inflation Protected IRA | Option 3 – State-Administered 401(k) |
|---|------------------------------------|---|--------------------------------------|
| Plan design and approval | \$573,698 | \$633,698 | \$823,698 |
| Establish partner/vendor agreements and interfaces | \$407,500 | \$627,500 | \$940,000 |
| Develop communications and marketing programs | \$912,500 | \$912,500 | \$1,652,500 |
| Total estimated state set-up and implementation costs | \$1,893,698 | \$2,173,698 | \$3,416,198 |
| State on-going costs | | | |
| Administration tasks | \$531,200 | \$591,200 | \$891,200 |
| Investment tasks | \$85,600 | \$205,600 | \$205,600 |
| Communications and marketing | \$640,500 | \$640,500 | \$840,500 |
| Fiduciary and compliance oversight | \$115,800 | \$115,800 | \$116,000 |
| On-going annualized state costs (Could potentially be recovered through program fees) | \$1,373,100 | \$1,553,100 | \$2,053,300 |