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A Big Deal for Small Business

Connecticut legislation may create the first state-administered retirement plan for small businesses, but will it cut out advisers and TPAs?

Judy Ward – 06/09/2008

Connecticut may become the first state to offer a state-administered retirement-savings plan to small businesses, self-employed people, and nonprofits. The proposal, introduced in February, aims to provide a lower-fee plan option for employers with fewer than 100 workers than they could negotiate on their own. At press time, the bill had passed the Senate, but, on the last day of the legislative session, it was not voted on in the House. The legislative session ended May 7.

Some political figures and others see the potential in this concept for a breakthrough in the decadeslong stalemate with plan offerings and participation rates at small companies. J. Mark Iwry, nonresident senior fellow at nonprofit public-policy organization The Brookings Institution, has been advocating a retirement coverage facilitator role for states since early in this decade. An approach like this pools the bargaining power of small employers, he says, and can make having a plan and participating in one more affordable. "It could be a catalyst for additional coverage [for small-business employees] by defining an option on the market that is simple, user-friendly, and reflects the state's negotiation of low fees," he says.

Others such as the American Society of Pension Professionals & Actuaries (ASPPA) see risks for everyone involved, including industry players. "This legislation is an absolute disaster for the industry," says Michael Callahan, a past ASPPA President and Founder of Southington, Connecticut-based Pentec, Inc., an employee benefits and actuarial consulting firm. "State dollars would be going to fund a business that is in competition with me. We built a country on the fact that we have free enterprise, and now we have collective socialism."

An Inefficient Market

As a registered investment adviser (RIA) and President of West Hartford, Connecticut-based Hunter Capital Advisors, Inc., Tim Burns has plenty of experience doing investment-provider searches for plans, including small employers. Many small companies do not have the knowledge on staff to prudently select and monitor investments, or the resources to hire a professional who can do it for them. Even when they can afford to hire a professional to guide the provider search, he says he often has trouble coming up with an economical option for them.

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"There are lots of alternatives, but I do not view [the micro plan environment] as an efficient market," Burns says. "Clearly, there is a scale issue: It costs more, at the margin, to service a small plan, but it goes beyond scale. The industry has not been forced to find more productive ways to service small plans. The industry has enjoyed good profit margins simply because it is such an inefficient market." Asked who charges small plans too much, he says, "It is the whole chain of intermediaries."

National statistics say that roughly 75% of small employers do not have a retirement plan, says Thomas

Woodruff, Director, Retirement and Benefit Services Division at the Connecticut Office of the State Comptroller. "The current regulatory and business model stacks the cards against small businesses," he says. For providers, finding and managing small clients is expensive. "It is very labor-intensive. The way that the industry deals with that is to create funds that build in high fees to pay for all this. It is the way that the market is set up. I do not assign blame."

The Connecticut bill aims to use the state's leverage to offer small businesses a better deal. Connecticut has a pool of defined contribution assets with about $2 billion from 40,000 participants in three state-employee plans: a 401(a), a 403(b), and a 457.

The small-business offering would include the same investment lineup as the state plans. Each plan would be a separate legal entity utilizing the state's investment pool, and each employer would be a plan sponsor. All administration would be done by a third-party administrator under contract to the state. An employer would have to provide plan information to participants and enroll participants, Woodruff says; an arrangement would be made to transmit contributions electronically to the third-party administrator (TPA) for investment.

Once the three state defined contribution plans pooled their assets, Woodruff says, fees went from 1.5%, on average, to less than 0.3%. If the bill becomes law, fees for small businesses that join the new setup could be about 50% less than they would be otherwise, he estimates, because they are part of a very large program instead of a micro plan. "We believe that somewhere between 1% and 1.5% of assets could be saved through this approach," he says.

If the bill passes eventually, the next time Connecticut goes out to bid on its TPA contract, handling the small-business funds would be added to the TPA's tasks. The fourth year of the state's current four-year contract with ING Retirement Services begins on July 1. If the bill had passed this session, Woodruff says, the new setup could have gone out for bid as early as this fall for a July 2009 start date. ING does intend to bid for the business again, spokesperson Deborah Pont says.

Joining the state's setup would be optional, both for small businesses that do not have existing retirement plans and those that do. "We are not interested in taking over existing plans," Woodruff says. "This would not be a zero-sum game, where we are fighting over plans."

The offering potentially could include several options, Woodruff says, including a 401(k), a SIMPLE IRA (individual retirement account), and a payroll-deduction IRA. "The bill leaves the door open for any tax-code-permissible plans to be offered," he says. Iwry thinks the state should focus on IRAs rather than a 401(k). "The state needs to steer clear of ERISA [Employee Retirement Income Security Act]," he says. An IRA is simpler to administer, and it also requires little or no employer contribution, he says, whereas many employers do make a 401(k) contribution and many workers expect it.

Some question where the fiduciary responsibility would lie, since state plans are exempt from ERISA. "We manage the plans as if they were ERISA plans, with regard to 404(c) and investments," Woodruff says. "We do not really see that the state would have any more fiduciary issues than we now have."

The state could take on some fiduciary responsibility for employers, Iwry says, but not eliminate it. For instance, the state could lessen employers' exposure by setting up a default investment for participants who do not make a choice. "However, to the extent that the state did that, the employer is still making the choice to participate in that plan as opposed to some other option," he says. "An employer would have at least some fiduciary responsibility, but the state could arrange to reduce the practical exposure."

Driving Out Intermediaries?

The fiduciary issue may play a big role in how many small employers go for an arrangement like this, Callahan says. If the state says it can provide a lower-cost alternative, as a fiduciary, "You are almost required to do it," he says, "or at least consider it."

Burns foresees some Connecticut employers drawn to the stability of the state, but anticipates less of an initial effect. "Realistically, there is so much inertia in this market, I am not sure it would have a large or immediate impact," he says. The bill does not help employers concerned about match costs, for example.

The legislation might have its biggest impact indirectly, Burns says, if it helps establish a new competitive benchmark for small-plan fees. "It would be a good standard to establish in that part of the industry," he says. "There is no question that it might lower the profits. So, it is in businesses' best interests to become as efficient as they are in the large-plan market."

A big efficiency push could come at participants' expense, Callahan warns. "The only way to lower costs is to drive out intermediaries, but who is going to do the servicing?" he says. Iwry envisions the concept working differently. "This is designed to be a market-led, private-sector-oriented system," he says. "My approach is to consider how the state can help the private market to work better, not to replace the private market."

It seems unlikely that a large vendor's staff will devote a great deal of time to individually visiting small businesses, Callahan says. However, Woodruff does not anticipate problems. Connecticut's TPA contract stipulates that the TPA handles employee communications, and the TPA maintains a plan-specific Web site for all three state-employee plans that contains account information, planning tools, asset-allocation tutorials and tools, and other investment-related information. "We would expect the TPA for these plans to provide similar services online for [small-business] participants," he says.

The state, along with the TPA, also prepares a quarterly newsletter for all participants and holds regular retirement-planning and investment seminars throughout Connecticut, Woodruff adds. "These seminars are held at state agencies, but the fact that we already have statewide services being provided would mean that we could expand these activities to deliver educational services more easily perhaps than other entities," he says. However, Callahan does not see how education could be accomplished at so many small-business sites "in any meaningful way."

When Maryland looked at this idea recently, Callahan says, "they found that the costs were prohibitively high for them to get involved with IRAs, let alone 401(k)s." A February 21 article in *The Hartford Courant* said that a state report on the proposed legislation in Maryland "agreed that a need exists among small businesses, but found challenges to implementing a state-administered retirement savings program. They include start-up costs, potential liabilities, and conflicts with federal law."

The state of Washington is moving ahead with a plan to offer retirement savings accounts through its public employee retirement system. Washington lawmakers are expected to consider the proposal in 2009.

In addition to Maryland and Washington, there already is talk of doing something similar in California (see sidebar), New Hampshire, and West Virginia, Iwry says.

"[The Connecticut legislation] is on a very, very fast track," Callahan says. If it passes eventually, he says, other states may move forward. "It is just starting to be fleshed out," Iwry says of other states.

Bill Would Open CalPERS to Private Sector Workers

Under a new proposal, Californians who do not have access to a retirement savings plan at work would be able to set up a 401(k)-style account through the state of California.

The bill, authored by Assemblyman Kevin de Leon, D-Los Angeles, is aimed at the six million employees in California who aren't offered a pension or retirement savings plan at work, according to the *San Jose Mercury News*. The plan has been backed by Republican Governor Arnold Schwarzenegger.

The proposal, Assembly Bill 2940, passed its first test in April when a committee that deals with retirement issues approved it on a 4-1 vote. The bill would make California the first state in the nation to open its public retirement plan to workers in the private sector, supporters said, although several other states are considering the idea. The program would allow employees at businesses without pension or defined contribution retirement plans to set up IRA-type savings accounts through the California Public Employees' Retirement System (CalPERS).

Participating workers would have pre-tax earnings deducted from their paychecks and deposited into the

savings accounts, and employers could choose to match those contributions. Workers would be able to carry the accounts from job to job.

Proponents said the plan would be administered with money raised from fees on participants, so no new taxpayer money would be needed—and the fees would be lower than those workers might be charged by a private investment firm, de Leon said, according to the news report. However, Assemblyman Kevin Jeffries, R-Lake Elsinore, who voted against the proposal, questioned whether government would muscle out private investment firms that offer retirement savings plans such as IRAs and 401(k)s, according to the *Sacramento Bee*.—*Nevin E. Adams*

*Illustration by Josh Cochran

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