TEACHERS' RETIREMENT BOARD

BENEFITS AND SERVICES COMMITTEE

SUBJECT: CalSTRS Roth IRA Program ITEM NUMBER: 6

ATTACHMENT(S): 1

ACTION: ___ MEETING DATE: May 6, 1999

INFORMATION: X PRESENTER: Mr. Derman

SUMMARY

In 1998, CalSTRS considered the addition of supplemental benefits to its core pension programs. CalSTRS currently offers a 403(b) tax deferred savings program to CalSTRS members, which is administered by State Street Bank. In order to determine which additional supplemental benefits to offer, CalSTRS commissioned William M. Mercer, Incorporated (Mercer) to conduct a feasibility study on the provision of supplemental benefits by CalSTRS. That study was presented to the Benefits and Services Committee in April 1998. The study indicated that Defined Benefit (DB) Program members are interested in additional retirement savings opportunities. Mercer also suggested that CalSTRS might consider sponsoring Roth IRAs as a way to meet members' desire for an additional retirement savings opportunity. The study also stated that there is no survey data on the level of interest in CalSTRS sponsored IRAs. The Committee requested that staff evaluate whether CalSTRS should offer Roth IRAs to CalSTRS members.

Background

Roth IRAs were created by the Taxpayer Relief Act of 1997 as a new type of IRA that individuals can use beginning in 1998. Roth IRAs contain several features that make them an attractive means of supplementing an individual's retirement income, including tax-free distributions and no minimum distribution age.

Staff compared the Roth IRA and the 403(b) as two means for DB Program members and Cash Balance Benefit Program (CBBP) participants to supplement their retirement income. In comparing the two, it is evident that the 403(b) program allows for five times the saving opportunity as the Roth IRA and allows contributions of pre-tax dollars. The Roth IRA requires contributions from post-tax dollars.

CalSTRS Administration of Roth IRAs

CalSTRS administration of a Roth IRA raises two primary issues:

- Is there sufficient demand for a CalSTRS Roth IRA, which could be generated by:

    1. The unique investment opportunity offered by a CalSTRS IRA;

    2. The increased confidence the member has from investing in a CalSTRS program;

    3. The cost of a CalSTRS IRA relative to alternative IRA administrators, and whether the demand was sufficient to pay the cost of administration.

- If offered, should CalSTRS administer it directly or contract with a third party, which would be influenced by:

    1. The relative cost of direct rather than third party administration;

    2. The availability of improved services by direct administration.

A review of these issues indicates that CalSTRS members have substantial choices in which to invest Roth IRA funds. Although CalSTRS could offer the CalSTRS portfolio as an investment option, such an option would be expensive to administer. Investing in a subset of the CalSTRS portfolio would not offer an option that is significantly different from options available elsewhere.

The cost charged to Roth IRA investors by other Roth IRA providers is only nominally more than the cost of investing in taxable funds. Consequently, it would be difficult for CalSTRS to charge less than a CalSTRS member could pay for a Roth IRA elsewhere. If the Board were to elect to sponsor Roth IRAs, it would have to invest in additional staffing, hardware and software. Because the Board decided in April to defer a decision on administering the 403(b) program in-house, an accounting platform would have to be purchased for the administration of the Roth IRA in-house. CalSTRS would be responsible for marketing the program, collecting contributions, acting as custodian of the individual accounts, answering questions about the program and individual accounts, investing the contributions, making benefit payments, returning excess contributions, maintaining beneficiary forms, loan administration, reporting to the IRS, and providing statements to participants. Given the widespread availability of Roth IRAs to members, and the cost that CalSTRS would incur to administer such a program, it is unlikely that CalSTRS could recover its costs from program administration fees. Moreover, given the experience to date with the 403(b) Program in which administrative fee revenue is less than costs, it is unlikely that CalSTRS could secure the services of a third party administrator.

RECOMMENDATION

Do not offer a Roth IRA at this time. CalSTRs members currently have access to numerous supplemental investment vehicles at a reasonable cost elsewhere. The Board should, however, inform members of the value of Roth IRAs and other supplemental investment vehicles in the CalSTRS Financial Education Program and other educational materials offered by CalSTRS.

BACKGROUND ON ROTH IRA

Pursuant to the 1997 Taxpayer Relief Act, Roth IRAs first became available on January 1, 1998. The maximum amount that an individual can contribute is $2,000 per year. Contributions to a Roth IRA are not deductible for federal or state income tax purposes. There are income limits as to who can contribute to a Roth IRA—single investors may invest $2,000 per year provided they earn less than $95,000 yearly. Individuals who earn up to $110,000 may invest lesser amounts. The Roth IRA is attractive to some investors because after the account has been held for at least five years and the individual is aged 59½, withdrawals are tax-free.

There are six general circumstances under which someone under age 59½ may take distributions from a Roth or a traditional IRA without incurring a 10% federal penalty for early distribution, including disability of the investor, or using the funds to purchase an initial home or pay college expenses.

Although CalSTRS does not currently offer IRAs, it does offer a 403(b) program for eligible members and participants. The 403(b) tax sheltered investment program allows members to contribute $10,000 a year on a pre-tax basis as a way to supplement their retirement income without income limits. The 403(b) program also allows members to make contributions through payroll deduction and the member has various investment options from which to choose.

Table A compares the major differences between the two supplemental retirement income programs.

TABLE A
COMPARISON MATRIX OF ROTH IRA AND 403(b)

	ROTH IRA	403(b)
Maximum Annual Contribution	$2,000	$10,000
Pre-Tax Contribution	No	Yes
Post-Tax Contribution	Yes	No
Loans permitted	Up to $10,000 for first-time homebuyer	Yes, for any reason
Income Caps controlling ability to contribute	$95,000 for maximum contribution for single filer, $150,000 for married filers	No
Taxed Qualified Distributions	No	Yes

DISCUSSION

If the Board chooses to offer members including Cash Balance (CB) Benefit Program participants, a Roth IRA, CalSTRS would need to submit an application to the Internal Revenue Service (IRS) for approval to offer such a program. As a sponsor of a Roth IRA, CalSTRS would be responsible for:

- marketing the program,
- collecting the contributions (which could occur through payroll deduction),
- acting as the custodian of the individual accounts,
- answering member and participant questions about individual's accounts,
- investing the contributions,
- making benefit payments (withdrawals),
- having a mechanism for returning excess contributions,
- maintaining beneficiary forms,
- allowing for loans for first time home buyers,
- collecting for the repayment of loans,
- being capable of reporting to the IRS individual account information with respect to contributions and distributions, and
- providing at least annual statements to the participants.

There are two primary issues associated with a decision by the Board to sponsor a Roth IRA

- Is there a demand for a Roth IRA administered by CalSTRS?
- Should a CalSTRS Roth IRA be administered directly by CalSTRS, as it does the Defined Benefit Program and the CB Benefit Program, or through a third party administrator, as is the case with the CalSTRS 403(b) program?

<u>Demand for a CalSTRS Roth IRA</u>

As of the end of 1998, there were about 7,500 mutual funds and probably hundreds of other savings vehicles in California, such as bank accounts, in which funds could be invested in a Roth IRA. Although many of the mutual funds, such as tax-free municipal bonds, may not be suitable for an investment with the built-in tax advantages of a Roth IRA, it is clear that the CalSTRS member has available to him or her thousands of options in which to invest funds in a Roth IRA. Accordingly, in order for a CalSTRS Roth IRA to be successful, CalSTRS has to offer something that is not readily available elsewhere. Those unique features could include

1. An investment vehicle not available in other Roth IRAs
2. Higher investor confidence because the IRA is administered by CalSTRS
3. Lower administrative costs

Unique investment vehicles

As mentioned above, Roth IRA investors already have thousands of investment options available to them. A CalSTRS Roth IRA program, however, could offer participants the CalSTRS portfolio as an investment, an option that is not specifically available to investors elsewhere. Such an option would offer a highly diversified investment in domestic stocks and bonds, and international equities, as well as, in the extreme, real estate and other alternative investments. Such diversification historically has resulted in a good rate of return with lower levels of risk and volatility. According to the 1998 Comprehensive Annual Financial Report, the total average annual return of the CalSTRS fund for the last ten years, through June 30, 1998, was 12.59%.

It should be noted, however, that there are mutual funds available that incorporate most of the components of the CalSTRS portfolio, such as domestic and international equities and debt. Contributions made to these asset allocation funds are invested in a variety of different ways to meet the individual needs of individual investors. Some funds have assets allocated to emphasize capital growth, while others allocate their assets to emphasize income. Consequently, IRA investors do have available to them investments that provide much of the diversification available in a CalSTRS portfolio.

In addition, the administrative cost to CalSTRS associated with investing Roth IRAs in the entire CalSTRS portfolio would be significant. Many of the investments, such as real estate and alternative investments, do not lend themselves to the small investments involved in a Roth IRA. For that reason, the Cash Balance (CB) Benefit Program funds have in the past been invested only in domestic stocks and bonds. Although consideration has been given to investing CB Benefit Program funds in other parts of the CalSTRS portfolio, CB Benefit Program investment values do not have to be determined on an individual account basis each day, which would be required with Roth IRA funds. Consequently, even if Roth IRA funds could legally be invested in the CalSTRS portfolio, it probably is not practical to do so without investing in more sophisticated investment accounting software than currently is used at CalSTRS. Acquiring this accounting software would increase the administrative costs of the Roth IRA program. As a result the Investments Branch staff indicates that Roth IRA contributions would be invested only in domestic stocks and bonds, a portfolio that is readily available to CalSTRS members investing in Roth IRAs with other financial institutions.

CalSTRS Name Identification

Even if CalSTRS was only able to offer investment opportunities to a CalSTRS member that could be found elsewhere, offering a Roth IRA to members might be appropriate if the increased investor confidence associated with investing with CalSTRS provided sufficient demand or a significant enough service to members. The experience that CalSTRS has had with its existing 403(b) Program does not indicate that the association with CalSTRS has had significant impact on the relative success of that program. The current 403(b) program has been offered to CalSTRS members since 1995, and currently has approximately 1,900 participants, and approximately $30.8 million in assets. There are a number of reasons that the level of participation in the CalSTRS 403(b) program has been low, some of which also would apply to a Roth IRA. For one, many school districts offer hundreds of alternative 403(b) programs, and

CalSTRS has had limited success in creating a unique presence in the 403(b) market, despite the fact that CalSTRS' administrative costs are well below those charged by alternative programs available to most members. A CalSTRS Roth IRA also would be competing with thousands of investment alternatives. Other 403(b) providers have been significantly more aggressive in marketing their 403(b) programs, while the CalSTRS marketing has been limited to the efforts of the CalSTRS third-party administrator, State Street Bank. CalSTRS has re-evaluated its entire 403(b) marketing program, and increased participation in the 403(b) program after refocusing the CalSTRS' 403(b) marketing effort might suggest a possibility for similar success in a Roth IRA.

Lower administrative costs

A third basis for CalSTRS members to choose to invest in a CalSTRS Roth IRA would be if CalSTRS could administer such a program at a lower cost than could alternative IRA sponsors. Most IRA investors pay a small annual fee, generally $10, to the fund sponsor to cover the costs of administering the Roth IRA, in addition to the normal asset-based administrative charge imposed by the fund itself. In some cases, no separate IRA administrative charge is imposed. CalSTRS 403(b) participants pay their administrative expenses through an asset-based fee, rather than a fixed dollar amount as is imposed on most Roth IRA investors. In order to compete with other Roth IRA investments, CalSTRS would need to be able to have a low basis point charge with lower or no additional charge for establishing the account and handling transactions. As is discussed below, however, the administrative requirements imposed on CalSTRS administering a Roth IRA would be significant.

Administration of a CalSTRS Roth IRA

If CalSTRS decided to offer a Roth IRA, and received the necessary statutory approval, CalSTRS would have two choices in administering the program: it either could administer it with CalSTRS staff, as is the case with the Cash Balance Benefit Program, or it could contract with a third party administrator, as occurs with the CalSTRS 403(b) Program.

If CalSTRS were to administer the Roth IRA directly, it would be required to perform the necessary accounting functions to collect and manage the funds. This would require the acquisition of an electronic information processing system to host the new IRA database. After START was implemented, it could be adapted to accommodate the accounting requirements of a Roth IRA. Alternatively, CalSTRS could acquire a separate accounting system to administer the IRA program. This could be the same system that could be acquired to administer the CalSTRS 403(b) Program internally.

There would be other administrative resources required to administer the Roth IRA. Initial and ongoing staff resource requirements would include:

- accounting staff for the necessary record keeping
- investment staff to invest the contributions
- product promotion staff to develop and execute a marketing strategy and produce necessary marketing materials
- legal staff to ensure that the Internal Revenue Code is complied with and to keep up on changes to the code

- information technology staff to work with the database for testing purposes and to ensure that it is accurate
- customer service staff and/or an automated voice response system to respond to inquires from program participants
- administrative staff to handle ongoing administrative duties required to successfully administer the program

Many of these costs would be fixed costs that would not increase until the level of participation increased beyond a specified level. In the case of the CalSTRS 403(b) Program, State Street Bank incurs annual costs of $472,000, which includes $204,000 for administration, $225,000 for marketing, and $43,000 for customer service, to support less than 2,000 participants. These costs are the ongoing costs to run the 403(b) program with an established infrastructure to manage individual accounts already in place. The Bank's administrative and customer service costs alone represent an average annual cost of over $130 per 403(b) program participant. Unless a CalSTRS Roth IRA had greater assets or participation or a lower administrative cost than does the 403(b) program, CalSTRS could not charge a competitive fee that would cover its costs.

The opportunity for a Roth IRA to generate significant enough revenue through an asset-based fee is different than with the CalSTRS 403(b). The amount of revenue generated under such a fee structure is directly dependent on the level of assets held in the accounts. Most existing 403(b) funds held by CalSTRS members in other programs are held in the form of annuities. Generally, such annuities impose very steep surrender charges if funds are withdrawn from the annuities during the initial years of the contract. These surrender charges can remain in effect for many years. Roth IRA assets are held to a much greater degree in more liquid mutual funds and bank accounts. This facilitates investors transferring existing Roth IRA assets to a CalSTRS program with no transaction costs paid by the investor. On the other hand, an individual can invest up to $10,000 annually in a 403(b) (although the average annual CalSTRS member contribution is only about $4,000), while annual contributions to a Roth IRA are limited to $2,000. It cannot be determined ahead of time whether the increased liquidity of existing Roth IRAs would offset the lower contribution limits to provide sufficient assets to pay all CalSTRS' costs of administering an IRA.

One limitation in CalSTRS' ability to impose lower administrative fees than competitors is that mutual funds and other financial institutions, the primary sponsors of IRAs, already have the capability to administer individual investment accounts and provide the requisite level of customer service. The additional administrative cost associated with a Roth IRA would be less for those other entities than it would be for CalSTRS, which does not currently administer individual accounts comparable to a Roth IRA, and therefore would have to establish that capability specifically for this program.

CalSTRS could have the option to use other resources to offset some of the costs of administering a Roth IRA. However, with both the CalSTRS 403(b) and an authorized deferred compensation program, existing state law requires that the fees charged the program participants pay the administrative costs of these individual programs. Consequently, depending on the provisions of legislation authorizing CalSTRS to offer a Roth IRA, the option of supporting a Roth IRA with other funds may not be available.

Alternatively, CalSTRS could contract with a third party administrator to manage the program. However, it would be difficult to secure the services of such an administrator unless the third party administrator had a reasonable expectation of earning a profit or at least offsetting all of its costs of program administration. As mentioned earlier, State Street Bank pays $472,000 annually to administer the CalSTRS 403(b) Program and provide customer support. In 1998, however, the Bank earned only $212,000 in fees from program participants, resulting in a loss of $260,000.

RECOMMENDATION

The Roth IRA is an excellent choice for many people when planning for a financially secure future. Given the widespread availability of alternative Roth IRA investments at relatively low cost, and the experience to date with the CalSTRS 403(b) program, however, it doesn't appear prudent at this time for CalSTRS to offer a Roth IRA to CalSTRS members. At such time that participation in the 403(b) program increases at a more self-sustaining level, the Board may wish to reconsider whether the conditions have changed to warrant offering a Roth IRA as an additional supplemental investment vehicle. Before it administered a Roth IRA, however, it would probably be more prudent to assume responsibility for administering the 403(b) Program. CalSTRS experience in administering a program that already exists would provide meaningful information to the Board in determining whether it is appropriate to offer and administer another supplemental investment program to CalSTRS members.

In the meantime, CalSTRS could include the features and merits of Roth IRAs, and other retirement vehicles, such as 403(b) programs, in the information provided to members in the CalSTRS Financial Education program, the CalSTRS website, and in CalSTRS publications and brochures. Such information can help educate CalSTRS members on the need to make additional investments to supplement the retirement income provided in the Defined Benefit Program and the Cash Balance Benefit Program.