Plan Governance & Administrative Issues Committee Report 19-03

Date: November 26, 2019

To: Committee

From: Staff

Subject: 2020 DCP Resource Review

Committee Members
John R. Mumma *Chairperson*
Joshua Geller
Wendy Macy
Thomas Moutes

Recommendation:
That the Plan Governance & Administrative Issues Committee (Committee) recommend to the Board of Deferred Compensation Administration (Board) that the Board approve a one-time 50% fee reduction to be administered on a date to-be-determine in calendar year 2020.

Discussion
At its March 20, 2018 meeting, the Board of Deferred Compensation Administration (Board) adopted staff's recommendation to convene the Committee on an annual basis to conduct a DCP resource review. This review includes analysis of the assumptions for key variables that are used in forecasting the long-term (ten-year) projections of the DCP reserve fund balances as well as recommendations, if any, for modifying DCP fees or expenses.

To assist the Committee in its review, staff has developed a supplementary report summarizing the status of key variables used to forecast the long-term projections of DCP reserve fund balances compared to the Plan's adopted target reserve (**Attachment A**). During the Committee meeting, staff will also project a spreadsheet forecasting tool so that the Committee may model additional scenarios for consideration.

A. Reserve Fund Target and Forecasting Assumptions

All of the City's internal administrative costs are required to be paid by participant fees. Two accounts are used to pay expenses: a fund held with the Third-Party Administrator (TPA), Voya, which acts as a repository for participant fees and from which most DCP expenses are paid; and a fund held within the City, from which travel and equipment purchases are made. To maintain stability within the fee structure, the DCP maintains a reserve balance. The target reserve amount is 50% of annual DCP operating expenses. As of September 30, 2019, the surplus was $3.4 million versus the target surplus of $1.4 million.

The Committee and Board each conducted a DCP resource review in February 2019. At the Board's February 19, 2019, meeting, following a Committee review which took place February 5, 2019, the Board approved the Committee's recommendations to revise budgetary assumptions regarding the long-term net growth rate in the number of DCP participants from 2% to 3% and the projected reimbursement rate for indirect Personnel Department/City Attorney compensation costs from 100% to 115%. The 2019 analysis indicated a stable projected outlook for the DCP's long-term reserve fund. Following is a summary of the current adopted long-term assumptions for key variables relating to the management of the DCP Reserve Fund:

Variable	Current
Plan Assets Growth Rate	7.0%
Net Enrollment Growth Rate	3.0%
Annual Expenses Increase Factor	2.0%
Special Rates Increase Factor: Personnel	115.0%
Special Rates Increase Factor: City Attorney	115.0%
Stable Value Fund Interest Rate	2.0%
Participant Fees: Basis Point Charge	0.09%
Participants Fees: Annual Dollar Cap	$115.00

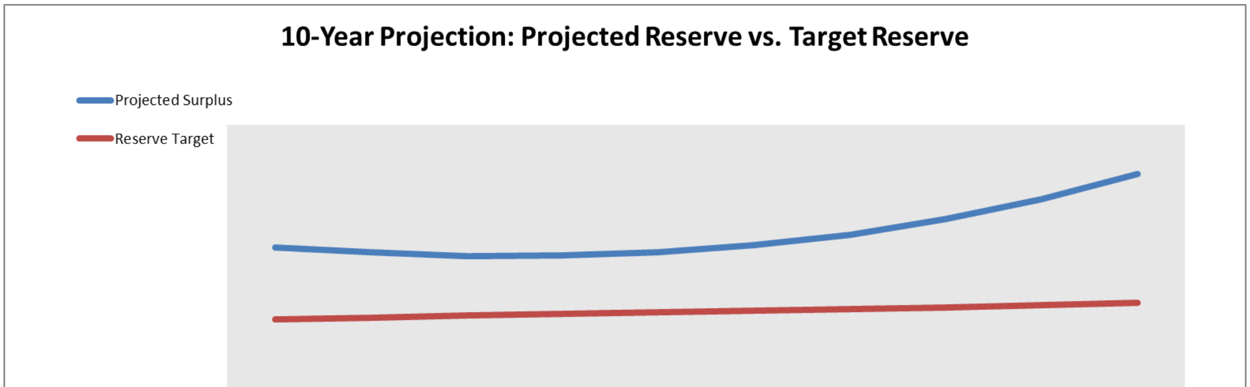
B. Plan Asset Growth

Over the past year, DCP assets rose 8%, which is consistent with historical averages. The five-year average growth rate is 7.8%, and the ten-year average growth rate is 9.1%. Growth rates incorporate both participant contributions as well as investment gains.

C. Reserve Fund Ten-Year Projection: Baseline Scenario

Staff has updated its ten-year forecast incorporating DCP data as of September 30, 2019, current expense information, and the Board's adopted assumptions for all of the variables used in generating projections. The projected ten-year reserve of $4.9 million is above the ten-year target reserve of $1.9 million. The reserve is projected to gradually decrease from 2020 until 2022 before steadily increasing from 2023 through 2029. In comparison to other scenarios in this report, this projection will be referred to as the "*Baseline Scenario*."

Baseline Scenario



	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Projected Surplus	$3,208,451	$3,093,026	$3,017,030	$3,018,503	$3,104,841	$3,252,220	$3,500,397	$3,858,613	$4,305,022	$4,881,502
Reserve Target	$1,574,433	$1,605,767	$1,653,973	$1,687,278	$1,721,610	$1,772,897	$1,809,368	$1,846,953	$1,901,582	$1,941,487

Following analysis, staff recommends the following concerning the current adopted assumptions related to **Asset Growth, Net Participation, Administrative Expense Inflation**, **Indirect Salary Cost,** and **Stable Value Fund Interest**:

- **Asset Growth (recommendation: no change)** - Both the historical averages, as well as the assumed long-term overall DCP investment rate of return provided by Mercer Investments (Mercer), support the 7.0% assumed growth rate assumption.
- **Net Enrollments (recommendation: no change)** – Net enrollments rose by an average annual rate of 3.5% over the last five years and 1.8% over the last ten years. If the economy and the City's financial position remain stable, further City hiring, as well as the potential expansion of the DCP Auto Enrollment Program (AEP), may support continued strong growth in the number of participant accounts. Countering this trend will be employee retirements and other separations from service, but if the DCP is successful in its goal to limit full account liquidations, retirements may not mean the closing of as many participant accounts.
- **Administrative Expense Inflation (recommendation: no change)** – Given that new ongoing expenses (including the costs of an annual DCP audit and outside tax counsel services) are included in base costs, staff finds that the 2% annual increase in overall costs (e.g., for direct salary costs) is reasonable.
- **Indirect Salary Costs (recommendation: no change)** – Special rates provided by the City Controller for calculation of indirect compensation costs for the Personnel Department and City Attorney are presently 99.39% and 87.45%, respectively. As indirect salary costs are volatile and tend to trend higher rather than lower, staff recommends that the long-term assumption for indirect cost special rates remain at 115%.
- **Stable Value Fund Interest (recommendation: no change)** – Longer-term rates of return on fixed-income assets will largely be driven by economic growth, monetary policy, and inflation. Given secular challenges in accelerating economic growth and inflation, interest rates appear unlikely to markedly increase in the foreseeable future. As a result,

staff recommends no change to the assumed 2% average rate of return for the Stable Value Fund.

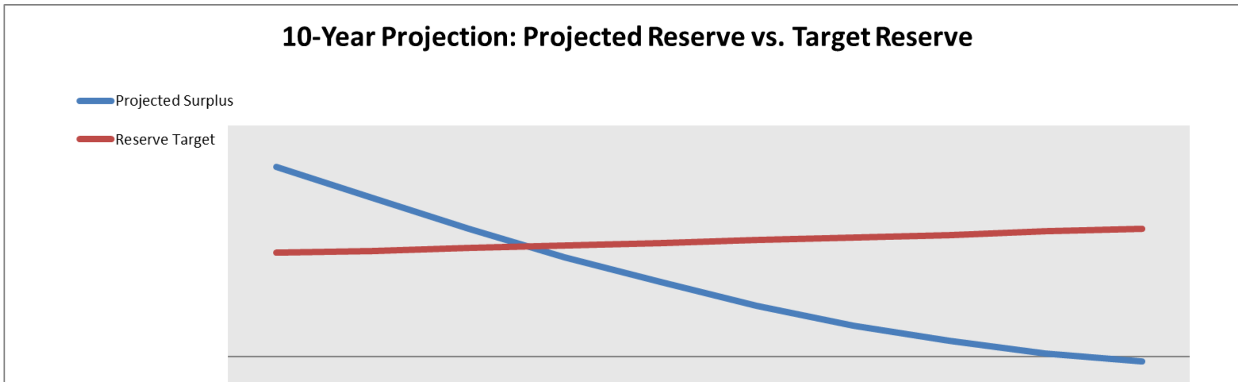
D. Reserve Fund Ten-Year Projection: 30% Decline Scenario

Asset values can fluctuate significantly in either direction based on market returns. Since 2008, the DCP and its participants have benefited from a long-running bull market in equities and a stable bond market, which more than offset declines in returns for the DCP's interest-bearing investment options (the Stable Value and FDIC-Insured funds). Assets have also been buttressed significantly in recent years by the growth in participant accounts and contributions.

The DCP has experienced market-related annual asset declines, however, with the worst being in 2008, which resulted in a year-over-year 22% decline. Between January 3, 2007, and March 9, 2009, the S&P 500 declined by 57%. As was the case in the Committee's 2019 review, staff has illustrated the impact of a sharp one-year (30%) reduction in DCP assets.

The following chart illustrates a scenario involving a 30% decline in assets incorporating all the assumptions noted in Section C of this report. In this scenario, the projected reserve would fall sharply from 2020 to 2028 and would ultimately be negative in 2029.

30% Decline Scenario



	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Projected Surplus	$2,877,664	$2,401,682	$1,933,143	$1,507,710	$1,130,239	$774,182	$476,376	$242,942	$48,685	$(68,099)
Reserve Target	$1,574,433	$1,605,767	$1,653,973	$1,687,278	$1,721,610	$1,772,897	$1,809,368	$1,846,953	$1,901,582	$1,941,487

E. Reserve Fund Ten-Year Projection: Impact of Participant Fee Reductions

Given the projected surplus over and above the target reserve, should the Committee wish to consider options available to reduce participant fees, staff has provided illustrations of three primary options for a broad-based fee reduction:

(1) **Basis Point Reduction Scenario** - Reducing the nine basis point asset-based fee presently assessed on all participant account balances to 0.085%, up to the present $115 fee cap;

(2) **Fee Cap Reduction Scenario** – Maintaining the current .09% asset-based fee but reducing the $115 fee cap to $110, which applies on a more limited basis to the approximately 14,800 participants (2% of total) who presently have balances above the fee cap threshold; and

(3) **Combined Scenario** - A combined scenario where both the administrative fee and fee cap are reduced by the amounts included in the prior two scenarios.

(4) **Combined Fee Reduction and Market Downturn Scenario** - A scenario where both the administrative fee and fee cap are reduced as described in the prior scenarios and a market downturn occurs that decreases participant assets by 30%.

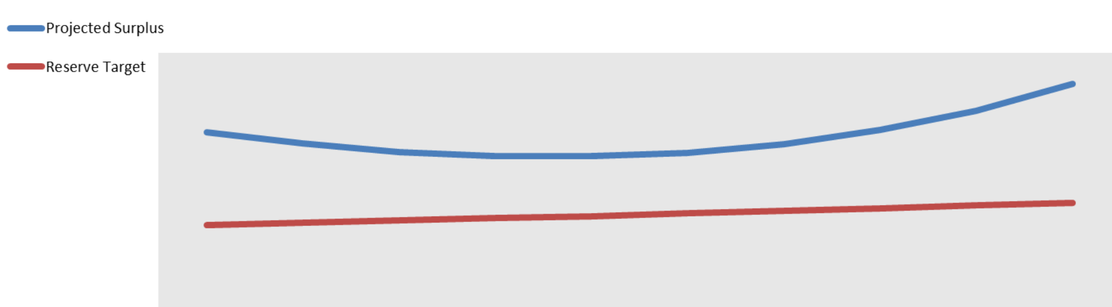
Other scenarios can be modeled via the spreadsheet projection at the Committee meeting.

(1) Basis Point Reduction Scenario

As indicated in the following chart, based on current assets and assumptions, reducing participant fees by one-half basis point (0.005%), from .09% to .085%, results in the projected reserve decreasing gradually through 2024 and increasing steadily afterward.

Basis Point Reduction Scenario (8.5 basis points)

10-Year Projection: Projected Reserve vs. Target Reserve



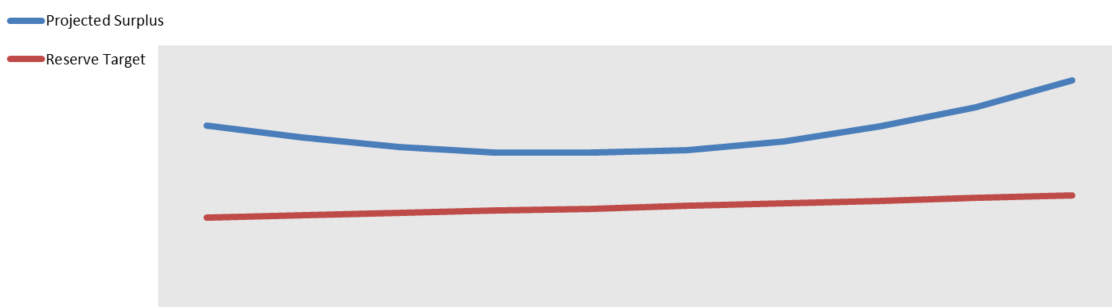
	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Projected Surplus	$3,147,194	$2,964,999	$2,816,311	$2,738,726	$2,739,174	$2,793,324	$2,940,393	$3,189,044	$3,516,811	$3,964,909
Reserve Target	$1,574,433	$1,605,767	$1,653,973	$1,687,278	$1,721,610	$1,772,897	$1,809,368	$1,846,953	$1,901,582	$1,941,487

(2) Fee Cap Reduction Scenario

As indicated in the following chart, based on current assets and assumptions, reducing the current fee cap from $115 to $100 results in the projected reserve decreasing gradually through 2024 and increasing steadily afterward, largely consistent with the Basis Point Reduction Scenario.

Fee Cap Reduction Scenario ($110 Fee Cap)

10-Year Projection: Projected Reserve vs. Target Reserve



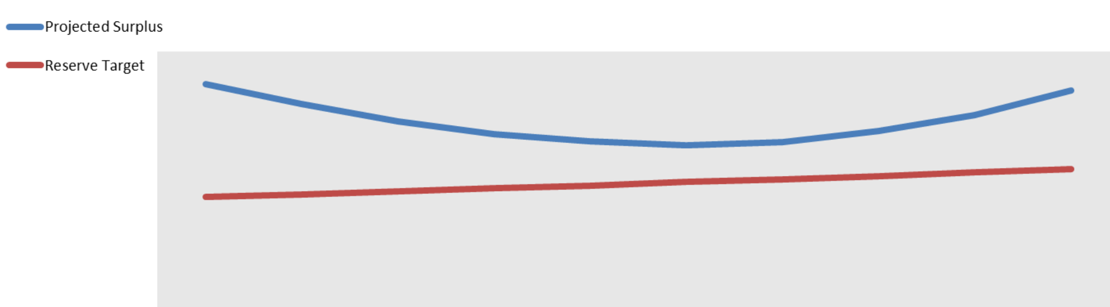
	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Projected Surplus	$3,130,269	$2,932,752	$2,770,608	$2,681,720	$2,673,328	$2,721,443	$2,865,650	$3,115,017	$3,447,515	$3,904,835
Reserve Target	$1,574,433	$1,605,767	$1,653,973	$1,687,278	$1,721,610	$1,772,897	$1,809,368	$1,846,953	$1,901,582	$1,941,487

(3) Combined Scenario

As indicated in the following chart, based on current assets and assumptions, reducing the asset-based fee to 0.085% and the fee cap to $110 results in the projected reserve remaining level through 2024 before increasing from 2025 onward.

Combined Scenario

10-Year Projection: Projected Reserve vs. Target Reserve

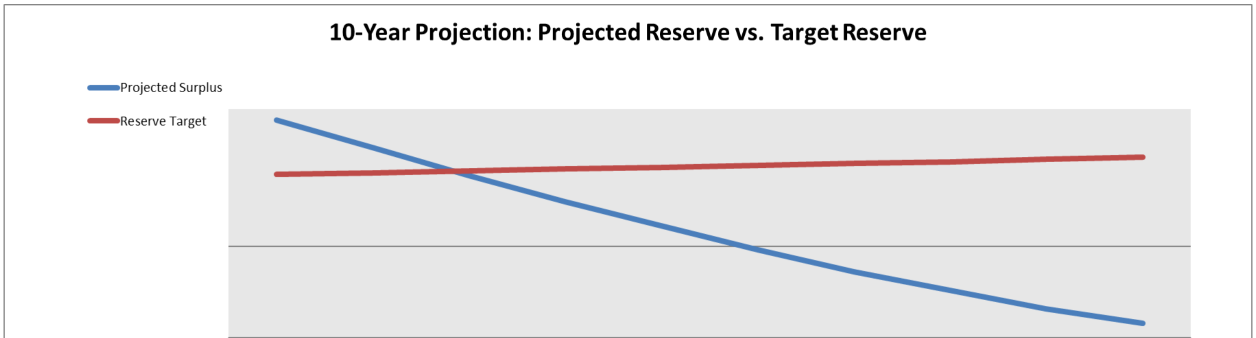


	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Projected Surplus	$3,069,012	$2,804,726	$2,569,888	$2,401,944	$2,307,661	$2,262,547	$2,305,646	$2,445,449	$2,659,305	$2,988,243
Reserve Target	$1,574,433	$1,605,767	$1,653,973	$1,687,278	$1,721,610	$1,772,897	$1,809,368	$1,846,953	$1,901,582	$1,941,487

(4) Combined Fee Reductions and Market Downturn Scenario

As indicated in the following chart, based on current assets and assumptions, reducing the asset-based fee to 0.085% and the fee cap to $110 during a market downturn that results in a 30% reduction in participant assets would cause the surplus to fall below its target in 2024 and would stabilize below the surplus in the years afterward.

Combined Fee Reductions and Market Downturn Scenario



	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Projected Surplus	$2,756,603	$2,151,790	$1,546,217	$975,084	$442,760	$(77,823)	$(550,373)	$(969,352)	$(1,360,569)	$(1,686,381)
Reserve Target	$1,574,433	$1,605,767	$1,653,973	$1,687,278	$1,721,610	$1,772,897	$1,809,368	$1,846,953	$1,901,582	$1,941,487

F. Findings and Recommendation

Staff does not recommend permanent reductions to asset-based fees or the fee cap based on this year's review. A significant or extended decline in the investment markets should be considered a real risk over the next ten years. A permanent reduction to participant fees could result in a reserve fund deficit in such a scenario. Staff's finding is that maintaining the current fee structure is appropriate based on current data and circumstances.

However, as part of this year's review, staff considered the merits and feasibility of an approach sometimes used in other agencies whereby the DCP could provide participants with a "fee holiday" which would suspend or reduce fees for a specific time period (e.g., one quarter). A one-time quarterly fee reduction would allow the DCP to reduce its excess reserve balance without committing to an ongoing fee reduction that might need to be reversed in the event of an extreme market downtown. Fee holidays, to the extent they could be repeated, would also have the virtue of helping the Board and staff to market the value and success of the DCP to participants and non-participants on a recurring basis. Voya has indicated it can administer a fee holiday.

A 50% fee-reduction holiday would result in a one-time reduction in the DCP reserve of approximately $350,000. This represents a modest reduction in the surplus, which would help to bring the actual reserve in alignment with the targeted reserve without creating the structural risks of a permanent fee reduction. Based on the projection of the baseline scenario, this would result in a 21% reduction of the DCP's excess surplus in 2020. Staff believes that taking a conservative approach would be prudent, given that the fee holiday can be replicated as frequently as the Board desires. The timing of any fee reduction would be determined based on operational requirements and opportunities to leverage the communications benefits. Staff, therefore, recommends that the Committee recommend to the Board that the Board approve a one-time fee holiday to be administered on a date to-be-determined in calendar year 2020.

Submitted by: ____________________________________

Mindy Lam, Personnel Analyst

Reviewed by: ____________________________________

Daniel Powell, Senior Personnel Analyst I

Reviewed by: ____________________________________

Jenny M. Yau, Senior Management Analyst II

Approved by: ____________________________________

Steven Montagna, Chief Personnel Analyst

Attachment A

CITY OF *Los Angeles*
DEFERRED COMPENSATION PLAN

PLAN BUDGET & RESOURCE REVIEW

November 26, 2019

Flow of Funds Overview

Revenue from
Participant Fees

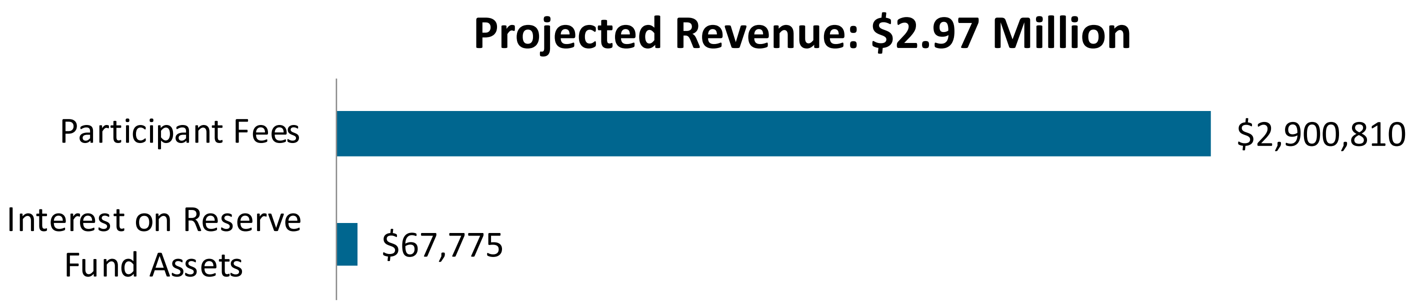
Reserve Fund
(Held with TPA)

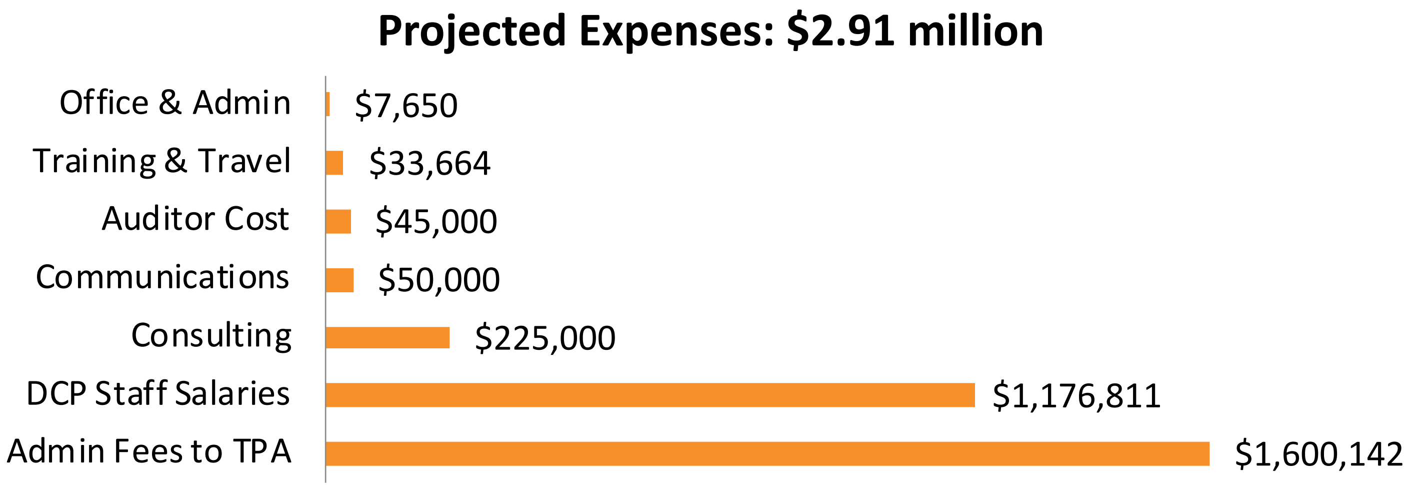
Expenses
TPA Fees
Staff Salaries
Consulting
Audits
Communications
Training (non-travel)
Elections

City Fund
#896

Expenses
Travel
Equipment

Projected 2020 Revenue & Expenditures

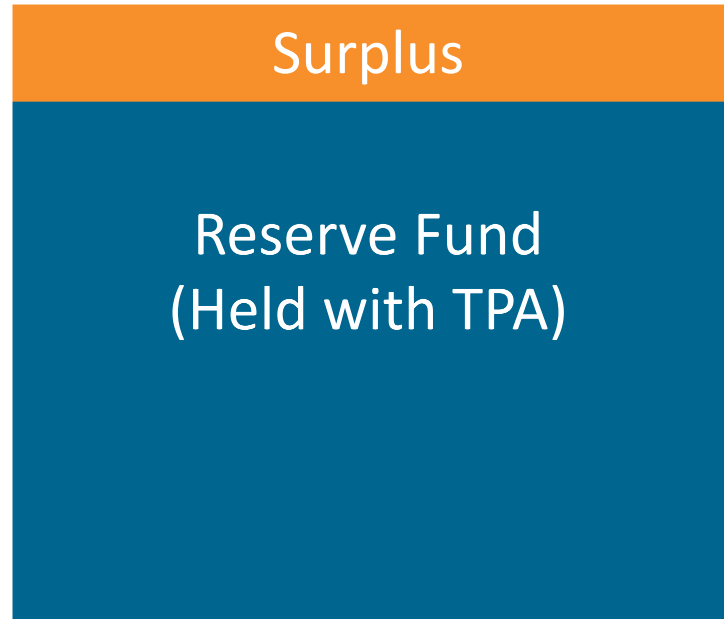




Expenses are expected to exceed revenue by $169,682, a deficit of 5.4%.

Surplus Target

- The adopted Reserve Fund surplus target is 50% of the DCP's annual operating expenses (equating to a target surplus of $1.45 million in 2020).
- Historically, the surplus has been maintained above that target.
- The Board previously established a "structural deficit" in relationship of revenues to expenses to gradually reduce the surplus.
- As of September 30, 2019, the surplus was approximately **$3.39 million**.



Reserve Fund Key Assumptions

Inflation for Certain Expenses	2.0%
Net Enrollment Rate	3.0%
Asset Growth Rate	7.0%
Stable Value Fund Interest Rate	2.0%
Asset-Based Participant Fee	0.09%
Participant Fee Cap	$115
Personnel Department Special Rate	115%
City Attorney Special Rate	115%

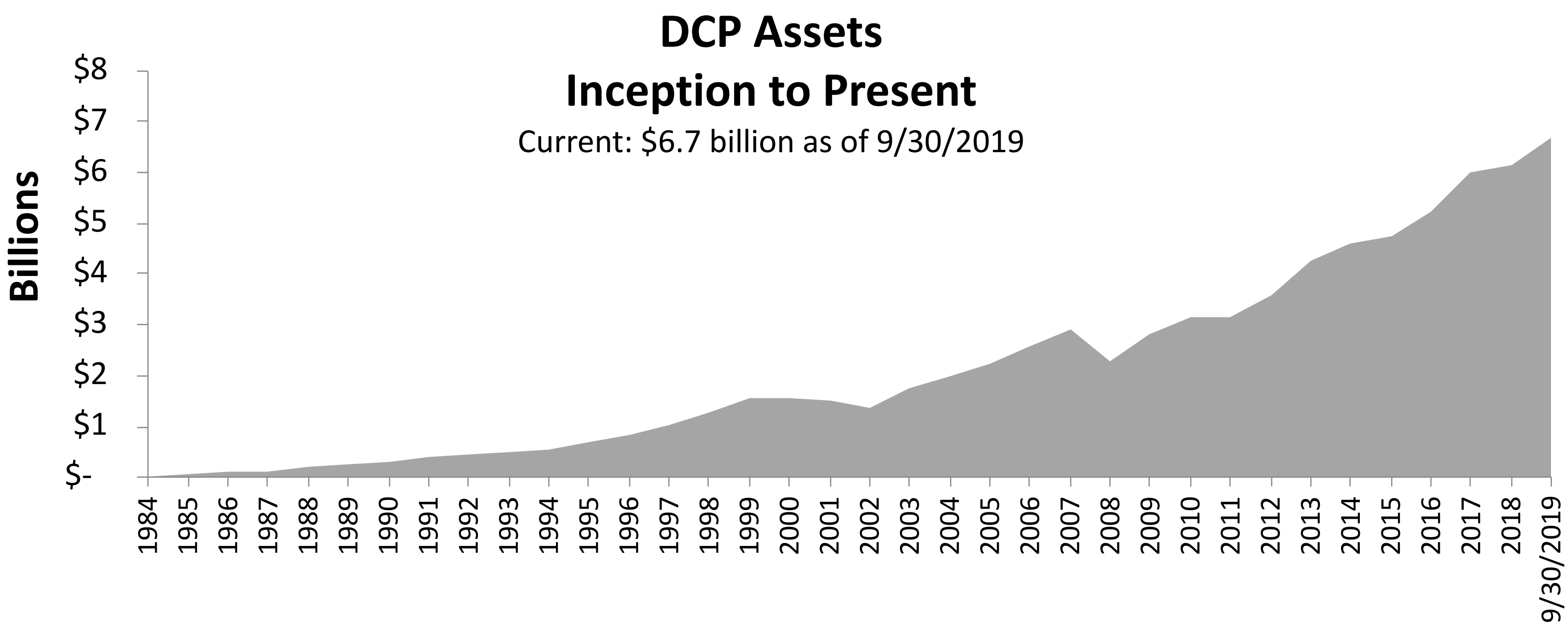
These assumptions were last updated by the Board on February 19, 2019.

Key Assumption: DCP Asset Growth

Current: 7.0%

Where Applied: Growth rate for DCP assets

Considerations: Recent growth has been higher than current assumption, but the bond/equity bull markets are aging.



Key Assumption: DCP Asset Growth

Year		Assets	% Change
1984	$	17,990,298	N/A
1985	$	48,584,697	170%
1986	$	84,762,277	74%
1987	$	126,921,243	50%
1988	$	180,395,336	42%
1989	$	249,105,465	38%
1990	$	303,691,355	22%
1991	$	378,018,448	24%
1992	$	441,306,161	17%
1993	$	516,401,147	17%
1994	$	564,392,235	9%
1995	$	702,779,928	25%
1996	$	831,689,383	18%
1997	$	1,029,129,147	24%
1998	$	1,285,271,264	25%
1999	$	1,564,440,301	22%
2000	$	1,578,565,882	1%
2001	$	1,508,545,448	-4%
2002	$	1,373,444,396	-9%
2003	$	1,737,260,679	26%
2004	$	1,973,665,625	14%
2005	$	2,230,031,810	13%
2006	$	2,566,734,158	15%
2007	$	2,909,282,960	13%
2008	$	2,279,918,897	-22%
2009	$	2,828,435,629	24%
2010	$	3,154,860,910	12%
2011	$	3,174,274,111	1%
2012	$	3,578,684,906	13%
2013	$	4,277,754,120	20%
2014	$	4,622,493,622	8%
2015	$	4,726,682,745	2%
2016	$	5,221,905,502	10%
2017	$	6,027,047,083	15%
2018	$	6,167,288,137	2%
9/30/2019	$	6,690,671,609	8%

Potential Growth Rate Scenarios	
Last 15 Years Average-->	**9.0%**
Last 10 Years Average-->	**9.1%**
Last 5 Years Average-->	**7.8%**
Actuarial Projection (Calculated Below) -->	**7.0%**

Projected Growth Rate Including ROR		
Current Assets	$	6,690,671,609
Net Annual Contributions (Last 12 Months)	$	95,531,088
Projected ROR (per Mercer)		5.36%
Earnings Growth	$	358,619,998
Projected Ending Balance	$	7,156,147,470
Projected Annual Growth Rate		**7.0%**

*The rate of return (ROR) was provided by Mercer in October of 2019. This value is projected over a 20-year horizon.

Key Assumption: Net Enrollment Rate

Current: 3%

<u>Where Applied</u>: Estimated growth in participant accounts

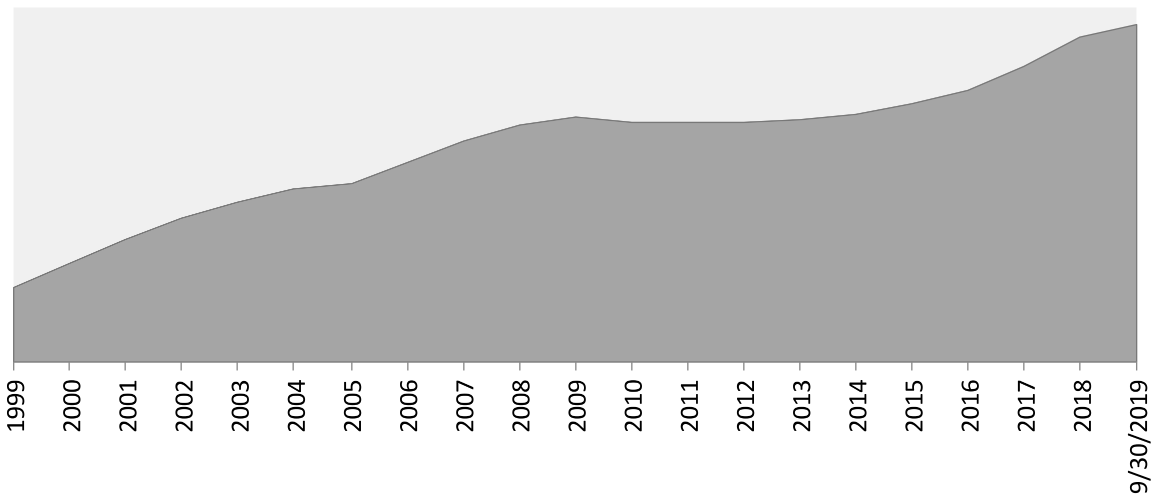
<u>Considerations</u>: Net growth rose sharply in 2018 but has leveled out somewhat in 2019 in a potential reversion to the mean. The average net enrollment rate over the last five years is 3.5% and is 1.8% over the last ten years.

Year Ending	Participants	Percent Change
1999	26,319	
2000	28,382	**8%**
2001	30,315	**7%**
2002	32,109	**6%**
2003	33,528	**4%**
2004	34,528	**3%**
2005	35,182	**2%**
2006	36,784	**5%**
2007	38,733	**5%**
2008	40,106	**4%**
2009	40,702	**1%**
2010	40,316	**-1%**
2011	40,348	**0%**
2012	40,325	**0%**
2013	40,389	**0%**
2014	40,906	**1%**
2015	41,818	**2%**
2016	43,076	**3%**
2017	44,938	**4%**
2018	47,508	**6%**
9/30/2019	48,548	**2%**

Participant totals as of 9/30/2019

Plan Participation: 1999 to Present

Current: 48,548 as of 9/30/2019



Key Assumption:
Administrative Expense Inflation

Current: 2%

Where Applied: Salary, training, and office/admin costs

Considerations:

- Positions are often filled at a lower level than the position authority.
- New labor MOUs provide cost of living adjustments that exceed 2% over the next few years.
- Training and admin costs have generally been lower than the budgeted amount historically, but training utilization has increased in recent years.
- Staff is currently developing the new Plan Manager position requested by the Board.

Key Assumption: Indirect Salary Costs

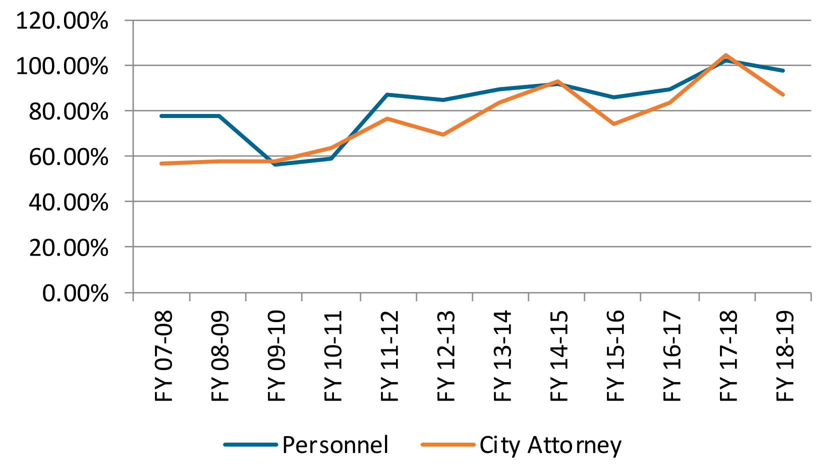
Current Assumptions:
Personnel Department – **115%**
City Attorney – **115%**

As Applied: Indirect salary costs
Considerations: Rates can be volatile and have large impact on costs

5-Year Average:
- Personnel – **93.78%**
- City Attorney – **88.70%**

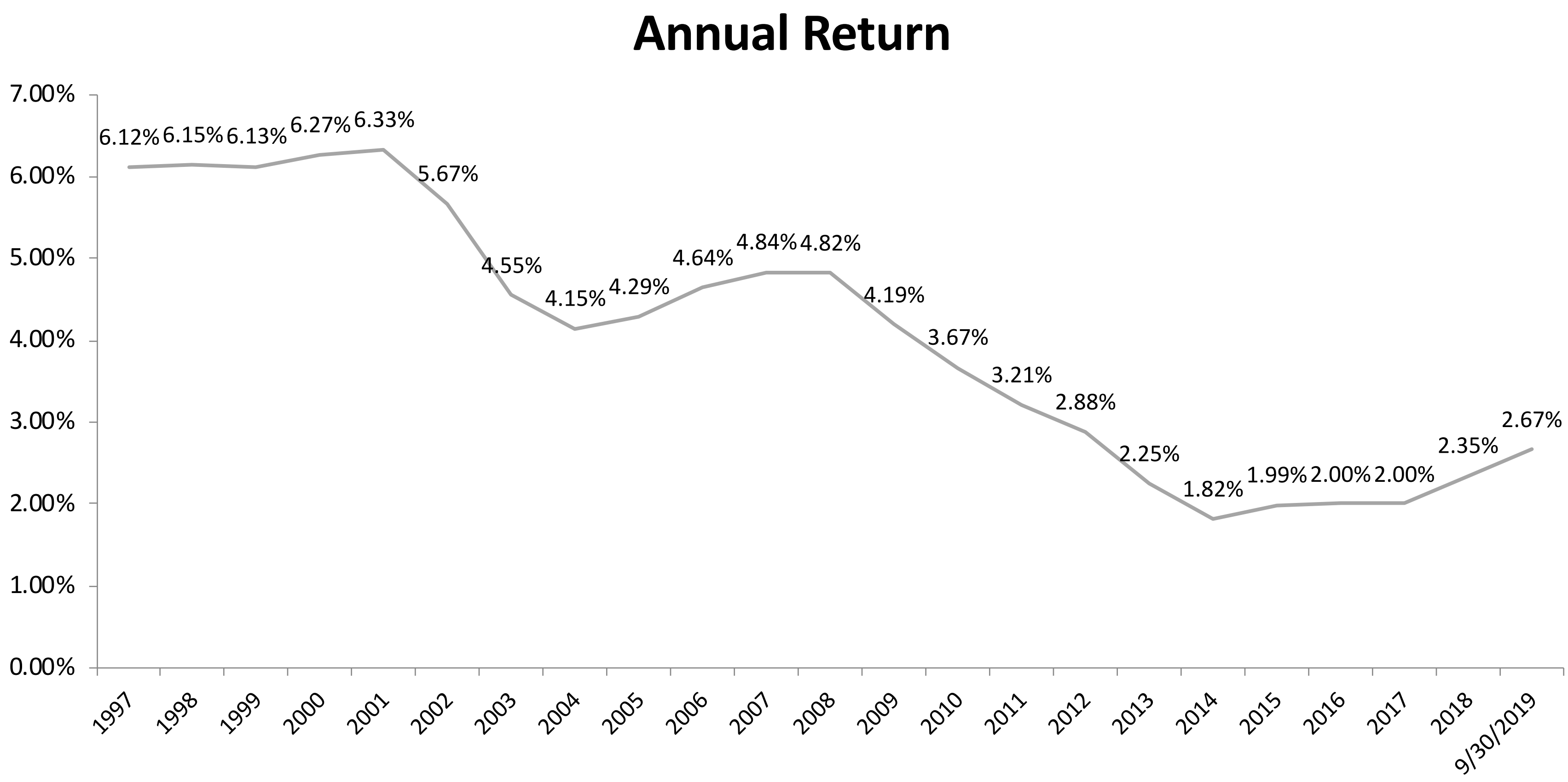
FY 18-19 #41 Special Rates (Final):
- Personnel – 99.39%
- City Attorney – 87.45%

Fiscal Year	Personnel	City Attorney
FY 07-08	78.30%	56.91%
FY 08-09	77.94%	57.96%
FY 09-10	56.43%	58.03%
FY 10-11	58.56%	63.59%
FY 11-12	86.77%	76.17%
FY 12-13	85.23%	70.19%
FY 13-14	89.30%	83.83%
FY 14-15	91.51%	93.09%
FY 15-16	86.28%	74.25%
FY 16-17	89.37%	84.04%
FY 17-18	102.34%	104.67%
FY 18-19	**99.39%**	**87.45%**
All Avg	**83.45%**	**75.85%**
5-Yr Avg	**94%**	**89%**



Key Assumption: Stable Value Fund Interest

Current: **2%**



Key Assumption: Participant Fees

Current:
Basis Points: **0.09%**
Fee Cap: **$115**

Where Applied: Fees are assessed against participant accounts up to the fee cap.

Considerations:
- Changes to Third-Party Administrator fee structure have created structural long-term savings
- Risk lies in a protracted market downturn that does not resolve in a short (few years) period of time.