Deferred Compensation Plan

BOARD REPORT 18-08

Date: March 20, 2018

To: Board of Deferred Compensation Administration

From: Staff

Subject: Proposed Adjustments to Participant Fees and 2018 Budget Adoption

Recommendation:

That the Board of Deferred Compensation Administration: (a) approve recommendations from the Plan Governance and Administrative Issues Committee to: (1) reduce the Plan's administrative fee presently assessed on all participant account balances by one basis point (0.01%), from .10% to .09%; (2) reduce the Plan's current administrative fee cap from $125 to $115; (3) direct staff to convene the Plan Governance and Administrative Issues Committee on an annual basis to review and conduct Plan fee and revenue analyses; and (b) adopt proposed Deferred Compensation Plan budget for Plan Year 2018.

Discussion:

At its January 16, 2018 meeting, the Board requested that the Plan Governance and Administrative Issues Committee ("Committee") conduct a review of long-term revenues and expenses and develop recommendations for further action. A Committee meeting subsequently convened on February 2, 2018. The Committee discussed potential adjustments of participant administrative fees. The Committee's recommendations are now being forwarded to the full Board for consideration.

To assist the Committee in its review, staff provided a supplementary report summarizing the status of key variables used to forecast the long-term projections of Plan reserve fund balances relative to the Plan's adopted target reserve (**Attachment A**). The assumptions were last reviewed and adopted by the Board in April of 2017. Staff also presented information to the Committee regarding a variety of fee reduction scenarios, and the Committee was able to model additional scenarios using a spreadsheet forecasting tool provided for use during the meeting. Following is key information considered by the Committee as part of preparing its recommendations to the Board.

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) which acts as a repository for participant fees and from which most Plan expenses are paid; and a fund held within the City, from which travel and equipment purchases are made. In order to maintain stability within the fee structure, the Plan maintains a reserve balance. The target reserve amount is 50% of annual Plan operating expenses. As of 09/30/17, the surplus was $3.1 million vs. the target reserve of $1.4 million.

On a quarterly basis staff updates its long-term (ten-year) projections for the surplus. The long-term projections rely on certain key assumptions that are adopted by the Board. In April 2017, following a Committee review which took place earlier in 2017, the Board adopted updated assumptions. The 2017 analysis indicated a stable projected outlook for the Plan's long-term reserve fund balance target. Following is a summary of the current adopted long-term assumptions for key variables relating to management of the Plan's Reserve Fund:

Variable	Current
Plan Assets Growth Rate	6.5%
Net Enrollment Growth Rate	2.0%
Annual Expenses Increase Factor	2.0%
Special Rates Increase Factor: Personnel	100.0%
Special Rates Increase Factor: City Attorney	100.0%
Stable Value Interest Rate	2.0%
Participant Fees: Basis Point Charge	0.10%
Participants Fees: Annual Dollar Cap	$125.00

B. TPA Fee Reductions

Since the transition occurred in October 2017, the Plan has realized the impact of significant cost reductions, including the following:

- The annual per-participant TPA account management fee has fallen from $36.97 to $32, a 13.4% reduction (saving approximately $220,000 annually)
- Rollover fees have been eliminated (saving approximately $75,000 annually)
- Hardship processing fees have been eliminated (saving approximately $100,000 annually)
- Asset Allocation Fund recordkeeping fees have been eliminated (saving approximately $72,000 annually)

Total approximate annual savings are **$685,000**. This figure does not include previously reported unanticipated savings in investment fund share class costs of approximately **$572,000** annually. In total, the change in TPAs has produced Plan fee reductions of approximately **$1.25 million**.

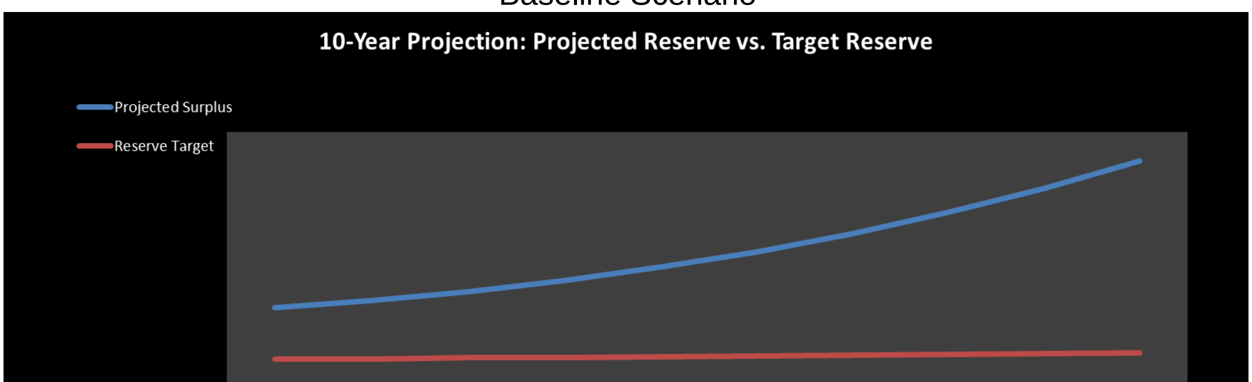
C. Plan Asset Growth

In addition, the Plan has experienced a sharp increase in assets over the past year. Total assets rose 15.4% from year-end 2016 to year-end 2017. This growth is a combination of participant contributions as well as investment gains, and far exceeds the long-term average 6.5% assumed growth rate of the Plan.

D. Reserve Fund Ten-Year Projection: Baseline Scenario

Given the changes that have occurred over the past year, staff indicated to the Committee that an updated review of the projected surplus was now warranted. The following chart incorporates updated Plan expense data together with the assumed long-term growth rate in Plan assets. The projected ten-year surplus at $8.9 million is significantly above the ten-year target reserve amount of $1.6 million. Plan revenues are projected to annually exceed expenses, with the projected surplus increasing each year and reaching $7.2 million above target by 2027. This projection will, for the purpose of comparison to other scenarios in this report, be referred to as the "*Baseline Scenario*."

Baseline Scenario



	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Projected Surplus	$3,336,699	$3,615,010	$3,943,196	$4,359,013	$4,869,502	$5,450,408	$6,140,970	$6,949,818	$7,854,392	$8,895,738
Reserve Target	$1,393,809	$1,413,679	$1,449,953	$1,470,840	$1,492,251	$1,530,096	$1,552,586	$1,575,631	$1,615,144	$1,639,335

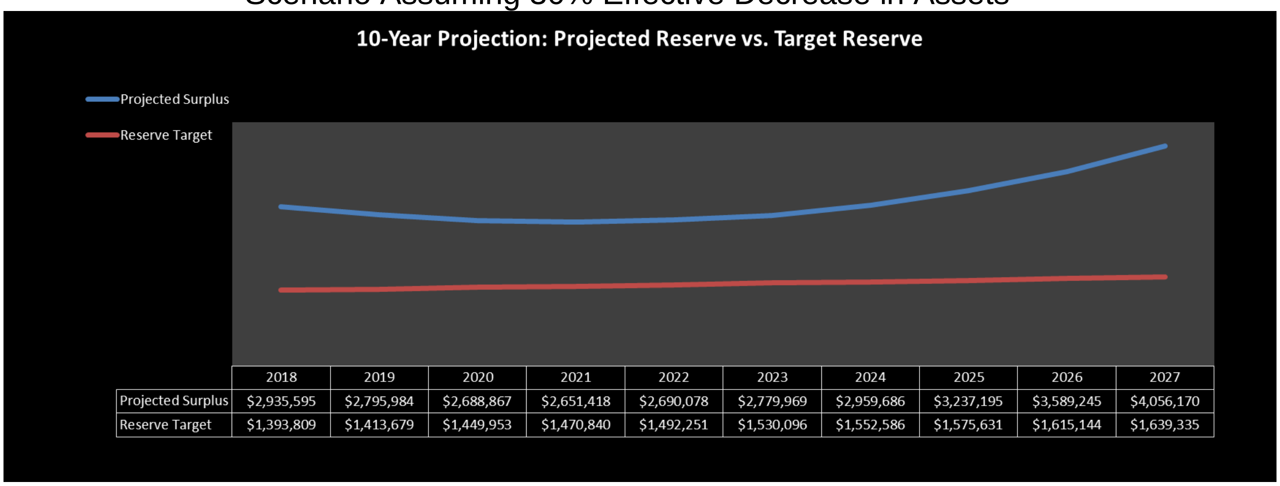
For the purpose of the analysis provided to the Committee at its February 1, 2018 meeting, staff assumed no changes to adopted adjustment factors related to **Asset Growth, Enrollment, Administrative Expense Inflation**, **Indirect Salary Cost,** and **Stable Value Fund Interest**. Rather, the Committee's analysis focused on evaluating scenarios for aligning the projected long-term reserve fund surplus with the target surplus by reducing participant fees.

Asset values can fluctuate significantly in either direction based on market returns. Since 2008, the Plan and its participants have benefited from a long-running bull market in equities and a stable bond market, which have more than offset declines in returns for the Plan's interest-bearing investment options (the Stable Value and FDIC-Insured funds). Assets are also buttressed significantly in all years by ongoing participant contributions, which in 2017 totaled approximately $229 million.

The Plan has experienced market-related annual asset declines, however, with the worst being in 2008 (-28%). Before considering a structural reduction in participant fees, staff's analysis therefore first focused on the impact of a sharp reduction in Plan assets on par with the 2008 decline. As a result, staff created a ten-year projection scenario in which the first year recorded a 30% decrease in Plan assets, with the projected long-term rate applied going forward.

The following chart illustrates this scenario. If a -30% decline occurred, staff projects an approximate $5 million reduction in the surplus at the end of the 10-year review period as compared to the *Baseline Scenario*. The projected surplus in this scenario would be $4.0 million, or approximately $2.4 million higher than the target $1.6 million.

Scenario Assuming 30% Effective Decrease in Assets



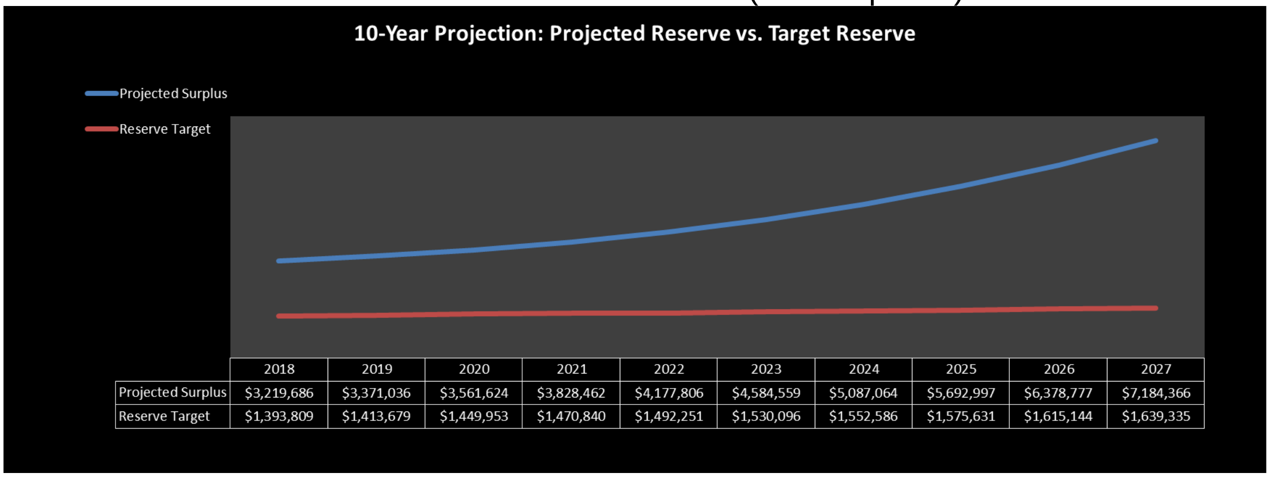
E. Reserve Fund Ten-Year Projection: Impact of Participant Fee Reductions

The Committee considered and discussed options available to reduce participant fees. Two primary options exist for a broad-based fee reduction: (1) reducing the ten basis point administrative fee presently assessed on all participant account balances, up to the present $125 fee cap; or (2) a reduction in the $125 fee cap, which applies on a more limited basis to the approximately 13,700 participants (or 31% of total participants) who presently have balances above the $125 fee cap threshold.

(1) Basis Point Reduction Scenario

As indicated in the following chart, based on current assets and the Board's current adopted assumptions, reducing participant fees by one basis point (0.01%), from .10% to .09%, results in an approximately $1.7 million reduction in the projected surplus at the end of the ten-year review period as compared to the *Baseline Scenario*. The projected surplus in this instance, referred to hereafter as the *Basis Point Reduction Scenario*, would be $7.1 million, or approximately $5.5 million higher than the target $1.6 million.

Basis Point Reduction Scenario (9 basis points)

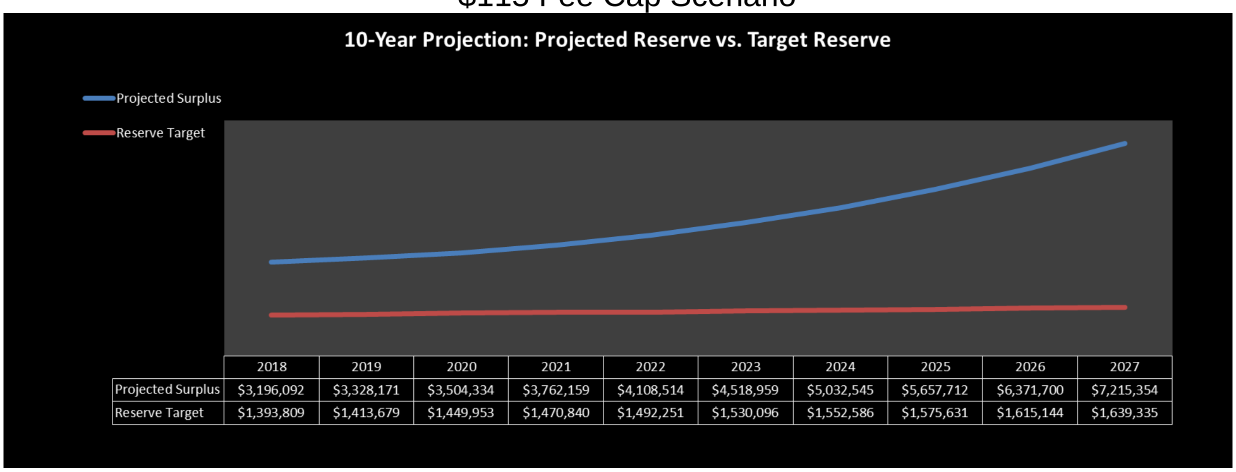


	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Projected Surplus	$3,219,686	$3,371,036	$3,561,624	$3,828,462	$4,177,806	$4,584,559	$5,087,064	$5,692,997	$6,378,777	$7,184,366
Reserve Target	$1,393,809	$1,413,679	$1,449,953	$1,470,840	$1,492,251	$1,530,096	$1,552,586	$1,575,631	$1,615,144	$1,639,335

(2) Fee Cap Reduction Scenario

As indicated in the following chart, based on current assets and the Board's current adopted assumptions, reducing the current fee cap from $125 to $115 results in an approximately $1.7 million reduction in the projected surplus at the end of the 10-year review period as compared to the *Baseline Scenario*. The projected surplus in this instance, referred to hereafter as the *Fee Cap Reduction Scenario*, would be $7.2 million, or approximately $5.6 million higher than the target $1.6 million.

$115 Fee Cap Scenario



	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Projected Surplus	$3,196,092	$3,328,171	$3,504,334	$3,762,159	$4,108,514	$4,518,959	$5,032,545	$5,657,712	$6,371,700	$7,215,354
Reserve Target	$1,393,809	$1,413,679	$1,449,953	$1,470,840	$1,492,251	$1,530,096	$1,552,586	$1,575,631	$1,615,144	$1,639,335

(3) Combined Scenario

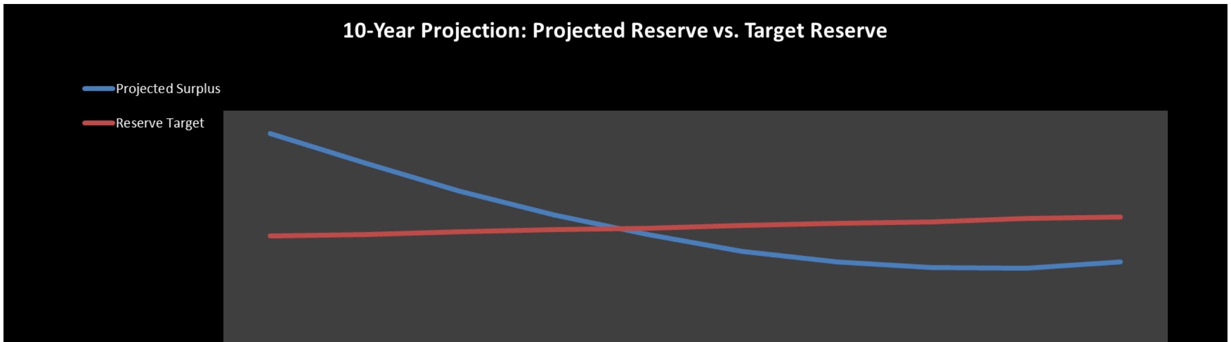
The Committee modeled a projected analysis of the *Combined Scenario* which included the following parameters:

- A 30% decline decrease in Plan assets in the first year

- A reduction of one basis point in Plan fees, from ten to nine basis points
- A reduction of $10 in the fee cap, from $125 to $115

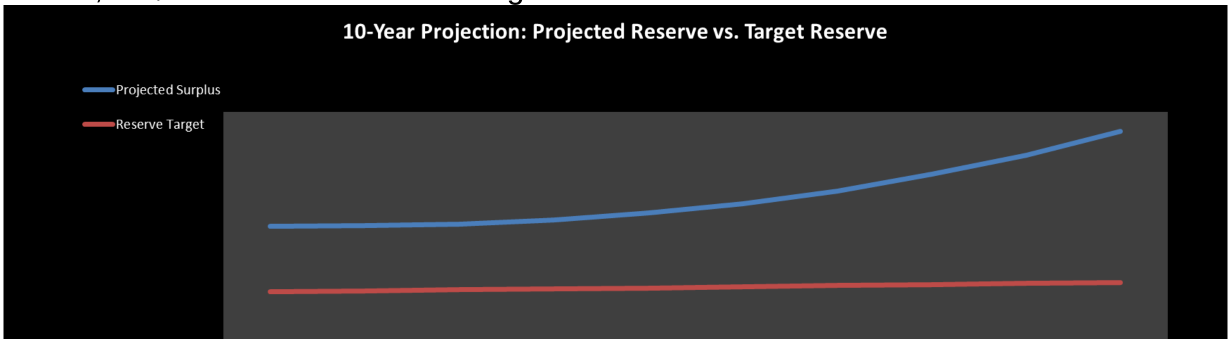
In this scenario, the projected ten-year surplus would be $1 million, approximately $0.6 million under the targeted reserve surplus.

Combined Scenario



	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Projected Surplus	$2,710,407	$2,331,411	$1,969,900	$1,662,182	$1,413,782	$1,198,852	$1,054,958	$988,973	$976,489	$1,056,612
Reserve Target	$1,393,809	$1,413,679	$1,449,953	$1,470,840	$1,492,251	$1,530,096	$1,552,586	$1,575,631	$1,615,144	$1,639,335

If the 30% decline is removed from the projection, the projected surplus would be $5.5 million, or $3.9 million above the targeted amount.



	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Projected Surplus	$3,079,079	$3,084,198	$3,122,761	$3,231,609	$3,416,818	$3,653,110	$3,978,640	$4,400,892	$4,896,086	$5,503,982
Reserve Target	$1,393,809	$1,413,679	$1,449,953	$1,470,840	$1,492,251	$1,530,096	$1,552,586	$1,575,631	$1,615,144	$1,639,335

The Committee understands that implementing a fee reduction is a significant step for the Plan, as it establishes a structural change in Plan revenues. The Plan's existing fee structure has been in place since 2007 and has been successful for many years in creating slight annual deficits which reduced the surplus reserve over and above the target reserve.

However, with the structural reduction in Plan fees resulting from the change in TPA providers as well as the growth in Plan assets, the Committee feels it is appropriate at this time to take action to reduce participant fees. Reducing the asset-based fee would reflect the benefits of positive actions taken by the Board in changing TPAs and apply across the participant base up to those with the fee cap. Reducing the fee cap takes an additional step towards equalizing the fee structure for larger account holders. Given these factors, the Committee recommends that the Board adopt fee reductions as indicated in the *Combined Scenario*, which includes: (1) a reduction of one basis point in Plan fees, from ten to nine basis points; and (2) a reduction of $10 in the fee cap, from $125 to $115. The Committee further recommends that fee and revenue analyses be conducted on an annual basis. The purpose of these annual analyses would be to update the status of long-term projections and evaluate whether additional adjustments should be contemplated. The next such analysis would take place in approximately December 2018 as part of preparing for Plan Year 2019 budget adoption.

F. 2018 Plan Budget Adoption

The Board's Deferred Compensation Plan Governance Policies and Bylaws/Fiscal Administration Policy, Section 5.2, provides that:

> *"At the beginning of each calendar year staff will present, for adoption by the Board, a recommended budget for the Trust Fund for that Plan Year. The Board, in structuring this budget, will maintain a long-term balance between revenues and expenditures that is consistent with avoiding volatility in the collection of participant fees. In furtherance of that objective, the Board shall maintain a prudent reserve in the Trust Fund to protect against fluctuations in Plan assets. The Board's Plan Year budgets shall be consistent with ongoing 5-year revenue/expense reviews as described in Section 5.1."*

Staff is recommending that the Board adopt staff's proposed budget for the Plan's 2018 calendar year as included in **Attachment B**. This attachment includes a narrative description of the assumptions and other relevant factors regarding each budgetary item. The projected budget also assumes the fee reductions proposed by the Committee, with an implementation date on or around April 1, 2018. Based on the Board's previously adopted assumptions and the Committee's proposed fee reductions, the projected 12/31/18 annual operating surplus would be approximately $128,000, and the total surplus would be approximately $3.4 million.

Submitted by: ____________________________
Matthew Vong

Approved by: ____________________________
Steven Montagna

Attachment B

DEFERRED COMPENSATION PLAN		
PROJECTED REVENUES/EXPENDITURES **Plan Year 2018**		
REVENUES		
Starting Balance on 01/01/18	$	3,326,329
Estimated Annual Administrative Fee Revenue	$	2,699,357
Estimated Interest Earnings	$	66,527
Opening Balance Plus Projected Revenues	**$**	**6,092,212**
EXPENDITURES		
Participant Administrative Fees Owed to TPA	$	(1,438,016)
Estimated Personnel Department Staffing Costs	$	(735,511)
Estimated City Attorney Staffing Costs	$	(153,543)
Estimated Consulting Costs	$	(185,000)
Communications	$	(75,000)
Travel/Training/Education	$	(32,357)
Elections Administration	$	(10,600)
Office and Administrative	$	(7,000)
Governmental Meetings	$	(500)
Total Estimated Expenditures	**$**	**(2,637,527)**
Annual Revenues Less Annual Expenditures	**$**	**128,356**
Projected Ending Balance on 12/31/18	**$**	**3,454,685**

Detail regarding budget items and assumptions included therein:

REVENUES

- ***Starting Balance on 01/01/18*** – The starting balance includes amounts held in both the Third-Party Administrator's Reserve Fund account and the City's Administrative Fee Trust Fund account.

- ***Administrative Fee Revenue*** – Projections for administrative fee revenues (amounts collected from participant accounts) reflect an increase in Plan assets. The one-year Plan assets growth rate assumption is 6.5% as established in the Strategic Plan revised by the Board in November 2013. Plan assets are impacted by both investment gains as well as participant contributions/rollovers.

- ***Interest*** – The assumed long-term average rate of return for the Stable Value Fund is 2.0%.

EXPENDITURES

- ***Participant Administrative Fees Owed to Plan Administrator*** – The City's contractual obligation to the Plan Administrator is $32.00 per participant. The long-term projected participant growth rate is 2%.

- ***Estimated Personnel Department and City Attorney Staffing Costs*** – The City's Plan funds certain percentages of direct and indirect staffing costs for its various positions, including the following position authorities: Chief Personnel Analyst; Senior Personnel Analyst II; Senior Personnel Analyst; Management Analyst (2 positions); Benefits Specialist; Administrative Intern; Assistant City Attorney; and Legal Assistant. The estimated expenditures for these positions for 2018 takes into account current paygrade levels and other factors. These rates reflect the most current Special Rate information for calculating indirect costs.

- ***Estimated Consulting Costs*** – The Board has contracts for various consulting services (investment, plan administration, and communications consulting), and also pays for tax consulting services on an as-needed basis via a contract administered by the City Attorney's Office. Staff projects a total of $185,000 in consulting expenditures for 2018.

- ***Communications*** – This category includes special communication costs over and above the amounts already included within the Plan Administrator budget.

- ***Travel/Training*** – For Plan Year 2017, the Board adopted an annual training/travel amount of $59,178. As seen in the following table below, actual training expenditures have consistently been significantly below adopted budget amounts in years past. Given this, the budgeted training/travel amount would be better suited to closely reflect the average of actual expenditures from prior years. Staff recommends a decrease in this amount to $32,357 for 2018.

Plan Year	Approved Budget	Actual Expenditures	Difference
2012	$ 55,187	$ 21,581	$ 33,606
2013	$ 89,894	$ 24,041	$ 65,853
2014	$ 59,178	$ 31,582	$ 27,596
2015	$ 59,178	$ 45,294	$ 13,884
2016	$ 59,178	$ 31,582	$ 27,596

- ***Office and Administrative*** – This category includes costs for staff equipment and other incidental administrative costs.

- ***Governmental Meetings*** – This category includes incidental costs for the conduct of governmental meetings.