Board Report 19-07

Date: February 19, 2019

To: Board of Deferred Compensation Administration

From: Staff

Subject: 2019 Resources Review and Annual Budget Adoption

Recommendation:
That the Board (a) approve recommendations from the Plan Governance and Administrative Issues Committee to revise assumptions used in projections for the DCP Reserve Fund to include increasing the assumption of annual net growth in participation from 2% to 3% and increasing the assumption of annual indirect salary reimbursement rates from 100% to 115%; and (b) adopt staff's proposed DCP budget for Plan Year 2019.

Discussion:
At its March 20, 2018 meeting, the Board adopted staff's recommendation to convene the Plan Governance & Administrative Issues Committee (Committee) on an annual basis in order to conduct a DCP resource review, which consists of reviewing key variable assumptions that are used in forecasting the long-term (10-year) projections of DCP Reserve Fund balances, and provide recommendations to the Board. The Committee convened on February 5, 2019, to conduct its annual review. To assist the Committee, staff provided a supplementary report summarizing the status of key variables used to forecast the long-term projections of DCP Reserve Fund balances compared to the DCP adopted reserve target (**Attachment A**). The Committee reviewed current assumptions and considered certain scenarios as to how potential market fluctuations or changes to participant fees could affect long-term projections of the DCP Reserve Fund balance. The Committee's recommendations and analysis are provided in this report.

A. DCP 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: an account held with the Third-Party Administrator (TPA) which acts as a repository for participant fees and from which most DCP expenses are paid; and an account held within the City, from which travel and equipment purchases are made. Together, these two accounts comprise the DCP Reserve Fund.

To maintain stability within the DCP Reserve Fund and participant fees, the Board has established a target reserve amount of 50% of annual DCP operating expenses. The target reserve amount is presently approximately $1.4 million. As of September 30, 2018, the DCP Reserve Fund balance (net of actual and incurred expenses) was $3.4 million.

Staff, on a rolling quarterly basis, updates the long-term (10-year) projections for the DCP Reserve Fund in connection with submitting requests for reimbursements of DCP staffing costs. The long-term projections rely on key variable assumptions adopted by the Board. Following the Committee's February 2, 2018 recommendations, the Board, at its March 20, 2018 meeting, adopted updated key variable assumptions summarized in the chart below:

Variable	Current
DCP 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	0.09%
Participants Fees: Annual Dollar Cap	$115.00

Overall, the 2018 analysis indicated a stable projected long-term outlook for the DCP's Reserve Fund balance target, including the approved fee reductions.

B. TPA Fees

As noted in the 2018 DCP Resource Review, the change in the DCP's TPA to Voya Financial (Voya) in October 2017 resulted in significant cost reductions, including the following:

- The annual per-participant TPA account management fee was reduced from $36.97 to $32, a 13.4% reduction, saving approximately $220,000 annually
- Rollover fees were eliminated, saving approximately $75,000 annually
- Hardship processing fees were eliminated, saving approximately $100,000 annually
- Asset Allocation Fund recordkeeping fees were eliminated, saving approximately $72,000 annually
- Investment fund share class changes produced savings of approximately $572,000 annually

These cost reductions contributed to the Board's ability to reduce participant fees in 2018.

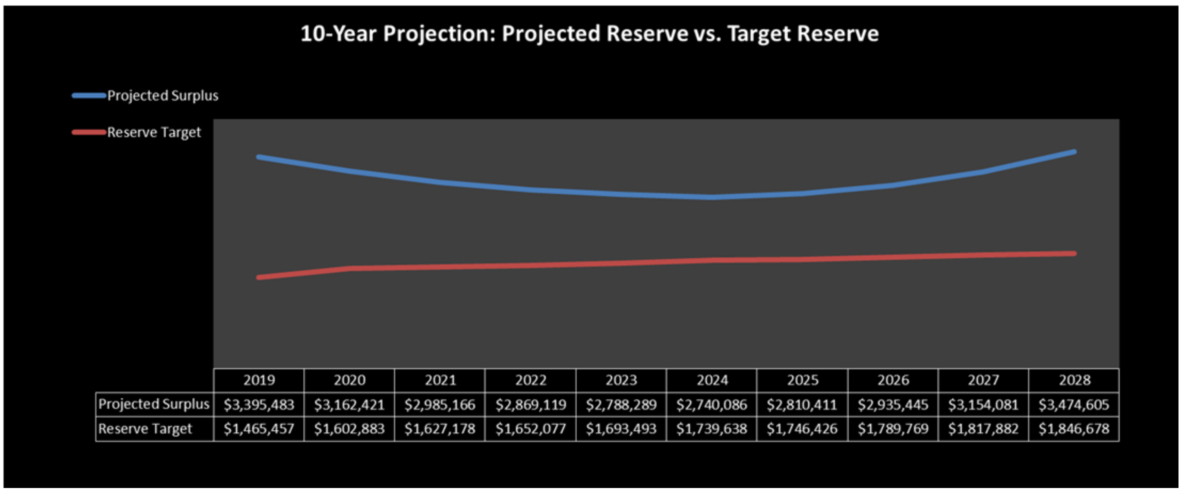
C. DCP Asset Growth

DCP assets rose 2% from year-end 2017 to year-end 2018, which is lower than historical averages. Five-year and 10-year average growth rates are 7.6% and 9.6%, respectively. Growth rates incorporate both participant contributions as well as investment gains. DCP average asset growth for five-year and ten-year periods still exceeds the 6.5% assumed growth rate.

D. Reserve Fund 10-Year Projection: Baseline Scenario

Staff updated the 10-year forecast incorporating DCP data as of September 30, 2018, current expense information, and the Board's adopted key variable assumptions used in generating projections. The 10-year forecast projects an ending balance of $3.5 million, an amount above the 10-year reserve target of $1.8 million. The projected surpluses are projected to incrementally decline through 2024 before gradually increasing between 2025-2028. For the purpose of comparison to other scenarios in this report, this projection will be referred to as the "*Baseline Scenario*."

Baseline Scenario



	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Projected Surplus	$3,395,483	$3,162,421	$2,985,166	$2,869,119	$2,788,289	$2,740,086	$2,810,411	$2,935,445	$3,154,081	$3,474,605
Reserve Target	$1,465,457	$1,602,883	$1,627,178	$1,652,077	$1,693,493	$1,739,638	$1,746,426	$1,789,769	$1,817,882	$1,846,678

At its February 5, 2019 meeting, staff provided the Committee with its findings and recommendations for each of the following key variable assumptions:

(1) No Recommended Changes to Assumptions

- **Asset Growth (no change)** – The Committee finds that, notwithstanding the 2018 below-average growth rate in DCP assets, both the historical averages, as well as the assumed long-term overall DCP investment rate of return provided by Mercer Investment Consulting, support the 6.5% assumed growth rate assumption.
- **Administrative Expense Inflation Factor (no change)** – Certain ongoing DCP expenses, including the costs of an annual DCP audit and outside tax counsel services, are included in base administrative costs. An inflation factor is applied since administrative costs tend to rise over long periods of time. The Committee finds that maintaining the 2% annual increase in overall costs (e.g., for direct salary costs) appears reasonable.

- **Stable Value Fund Interest (no change)** – Longer-term rates of return will largely be driven by economic growth. The current economic expansion continues to be one of the longest on record and staff's and the Committee's finding is that the risk of a decline in interest rates, perhaps a protracted decline, supports maintaining an assumed 2% average long-term interest rate for the Stable Value Fund.

(2) Recommended Changes to Assumptions

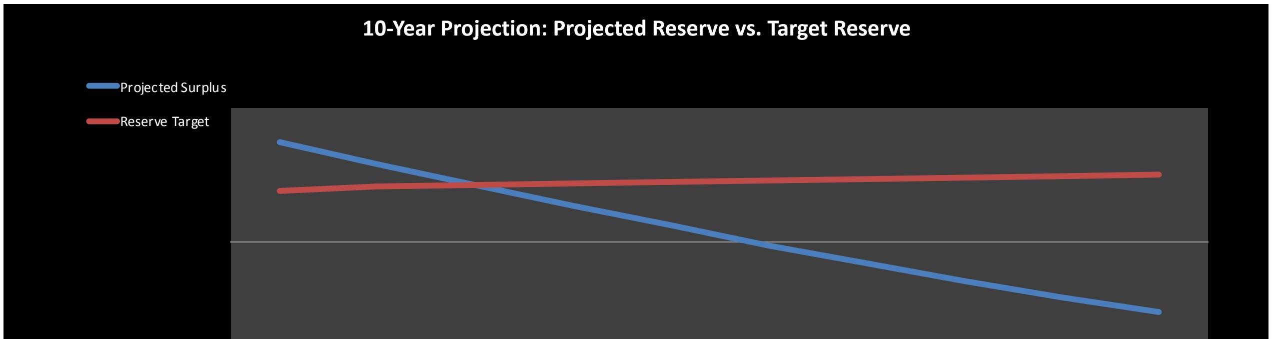
- **Net Participation (recommendation: increase assumed annual growth from 2% to 3%)** – Net participation rose by 6% in calendar year 2018 and over the past five years has increased by over 3% annually. Continued City hiring, and the expansion of the DCP Auto Enrollment Program, may continue to support strong growth in the number of participant accounts. In addition, based on the Board's adopted goals for Fiscal Year 18-19, staff is developing and implementing engagement strategies for improving participant outcomes and limiting full account closures due to employee retirements and other separations from service. The Committee recommends increasing the assumption for annual net participation from 2% to 3%.
- **Indirect Salary Costs (recommendation: increase assumed ten-year average rate to 115%)** – Special rates provided by the City Controller for calculation of indirect costs for the Personnel Department and City Attorney are presently 102.3% and 104.7%, respectively. As indirect salary costs tend to trend higher, the Committee recommends increasing the assumption for indirect cost special rates to 115%.

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

Asset values can fluctuate significantly in either direction based on market returns. The Committee reviewed how potential market fluctuations can affect long-term projections of the DCP Reserve Fund balance. Since 2008, the DCP 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 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.

However, the DCP has experienced market-related annual asset declines, with the most severe being in 2008 (28% decline). As was the case in the 2018 DCP resources review, staff developed an illustration of the impact of a sharp reduction in DCP assets on par with the 2008 decline. The following chart illustrates the impact of a 30% decline in assets incorporating all of the modified assumptions noted in Section D of this report. In this scenario, the projected reserve would become negative beginning in 2024. Participant fees would, therefore, need to be increased in order for the DCP to fulfill its expense obligations.

30% Decline Scenario



	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Projected Surplus	$3,001,474	$2,341,776	$1,705,528	$1,096,011	$484,975	$(132,574)	$(673,297)	$(1,203,734)	$(1,687,893)	$(2,120,573)
Reserve Target	$1,511,475	$1,659,850	$1,694,400	$1,730,033	$1,782,679	$1,840,569	$1,859,635	$1,915,811	$1,957,329	$2,000,125

F. Reserve Fund 10-Year Projection: Impact of Participant Fee Reductions

Similar to the 2018 DCP Resource Review, the Committee considered and discussed the following options available to reduce participant fees.

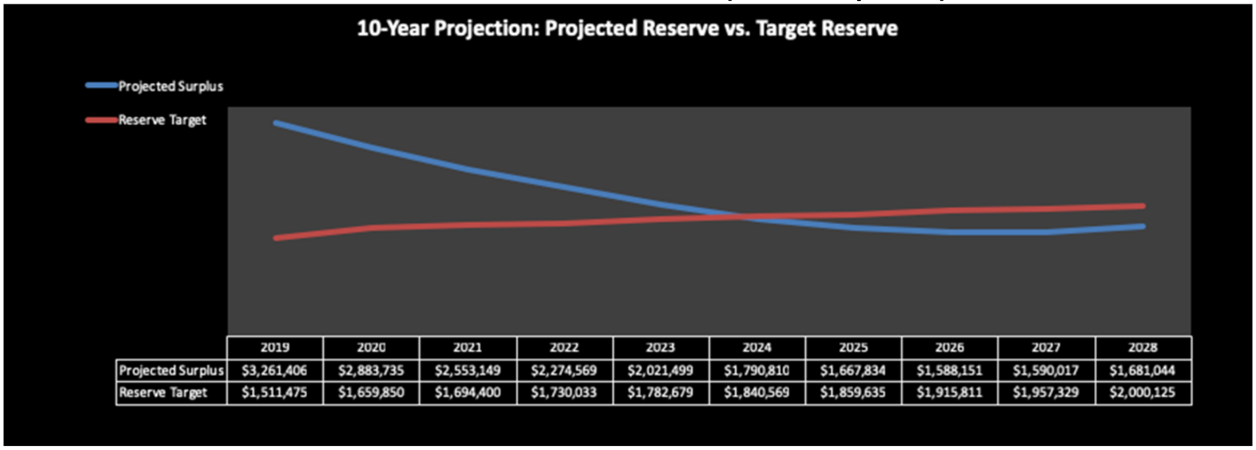
(1) **Basis Point Reduction Scenario** - Reducing the nine basis point asset-based fee presently assessed on all participant account balances to 0.085%, up to the present $115 fee cap
(2) **Fee Cap Reduction Scenario** – Maintaining the current .09% asset-based fee but reducing the $115 fee cap to $110, 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
(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

The Committee reviewed the following illustrations of three primary scenarios for a broad-based fee reduction as listed below:

(1) Basis Point Reduction Scenario

As indicated in the following chart, based on current assets and updated assumptions, reducing participant fees by one-half basis point (0.005%), from .09% to .085% results in the projected reserve falling below target in 2024 and continuing to gradually decline through 2026 before reversing trend.

Basis Point Reduction Scenario (8.5 basis points)

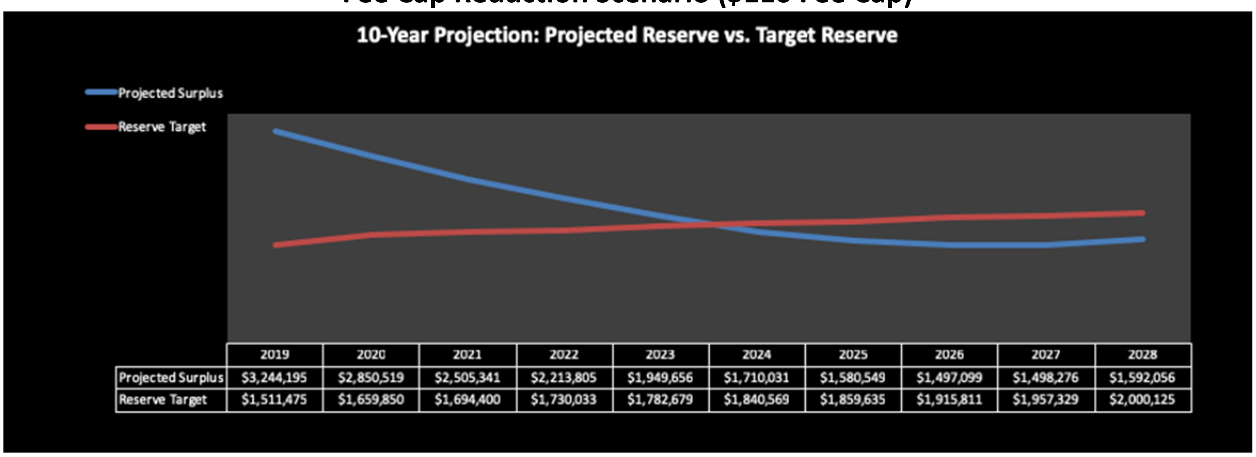


	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Projected Surplus	$3,261,406	$2,883,735	$2,553,149	$2,274,569	$2,021,499	$1,790,810	$1,667,834	$1,588,151	$1,590,017	$1,681,044
Reserve Target	$1,511,475	$1,659,850	$1,694,400	$1,730,033	$1,782,679	$1,840,569	$1,859,635	$1,915,811	$1,957,329	$2,000,125

(2) Fee Cap Reduction Scenario

As indicated in the following chart, based on current assets and updated assumptions, reducing the current fee cap from $115 to $110 results in the projected reserve falling below target in 2024 and continuing to gradually decline through 2027 before reversing trend in 2028.

Fee Cap Reduction Scenario ($110 Fee Cap)

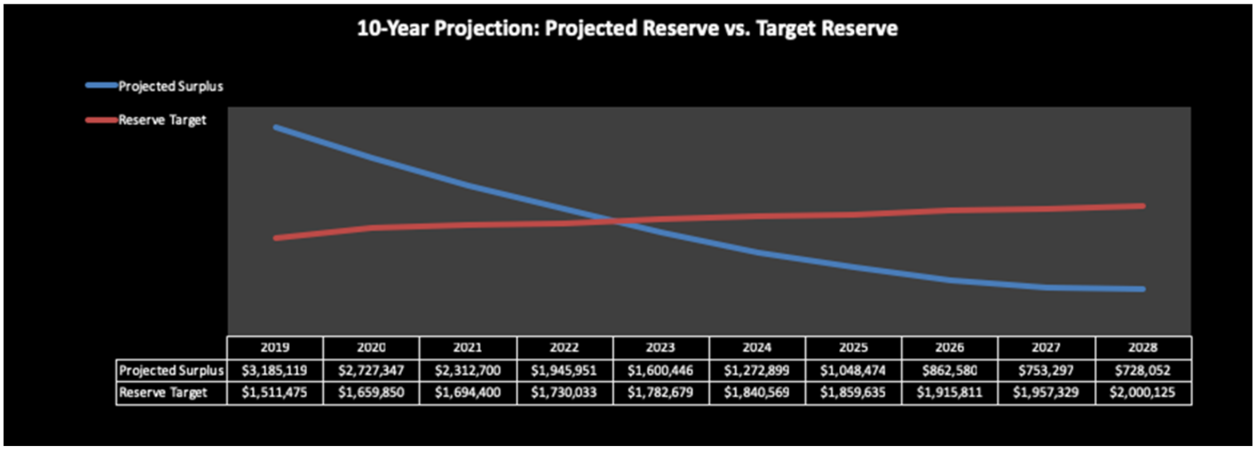


	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Projected Surplus	$3,244,195	$2,850,519	$2,505,341	$2,213,805	$1,949,656	$1,710,031	$1,580,549	$1,497,099	$1,498,276	$1,592,056
Reserve Target	$1,511,475	$1,659,850	$1,694,400	$1,730,033	$1,782,679	$1,840,569	$1,859,635	$1,915,811	$1,957,329	$2,000,125

(3) Combined Scenario

As indicated in the following chart, based on current assets and updated assumptions, reducing the asset-based fee to 0.085% and the fee cap to $110 results in the projected reserve falling below target in 2023 and continuing to gradually decline through 2028, with no reversal in trend.

Combined Scenario



	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Projected Surplus	$3,185,119	$2,727,347	$2,312,700	$1,945,951	$1,600,446	$1,272,899	$1,048,474	$862,580	$753,297	$728,052
Reserve Target	$1,511,475	$1,659,850	$1,694,400	$1,730,033	$1,782,679	$1,840,569	$1,859,635	$1,915,811	$1,957,329	$2,000,125

G. DCP Reserve Fund Review Conclusions

The Committee was cognizant that even modest reductions in asset-based fees and/or a reduction in the fee cap would result in the projected reserve falling below target and that a significant and/or extended decline in the investment markets should be considered a real risk over the next 10 years. Based on the analysis provided by staff, the Committee does not recommend reductions to asset-based fees or fee cap at this time.

However, following its review, the Committee recommends that the Board revise assumptions used in projections for the DCP Reserve Fund to include increasing the assumption of annual net growth in participation from 2% to 3% and increasing the assumption of annual indirect salary reimbursement rates from 100% to 115%. All other assumptions would remain as adopted by the Board in 2018.

Variable	2018	Recommended
DCP Assets Growth Rate	6.5%	6.5%
Net Enrollment Growth Rate	2.0%	**3.0%**
Annual Expenses Increase Factor	2.0%	2.0%
Special Rates Increase Factor: Personnel	100.0%	**115.0%**
Special Rates Increase Factor: City Attorney	100.0%	**115.0%**
Stable Value Interest Rate	2.0%	2.0%
Participant Fees: Basis Point Charge	0.09%	0.09%
Participants Fees: Annual Dollar Cap	$115.00	$115.00

* The table above reflects the Committee's recommended revisions to the assumptions used in projections for the DCP Reserve Fund contained in this report. Revisions are identified in red.

H. 2019 DCP Budget Adoption

The Board's Deferred Compensation Plan Governance Policies and Bylaws/Fiscal Administration Policy, Section 5.2, provides that the Board adopt a budget for each Plan Year. Staff recommends that the Board adopt staff's proposed budget for the DCP's 2019 Calendar Year as included in **Attachment B**. The attachment includes a narrative description of the assumptions and other relevant factors regarding each budgetary item. The projected budget also assumes the changes in budgetary assumptions recommended by the Committee. If the Board adopts the Committee's proposed key variable assumption changes, the projected December 31, 2019 annual operating surplus would be approximately $91,689, and the total surplus would be approximately $3.6 million.

Submitted by: ________________________________
Matthew Vong/Kevin Hirose

Reviewed by: ________________________________
Isaias Cantú

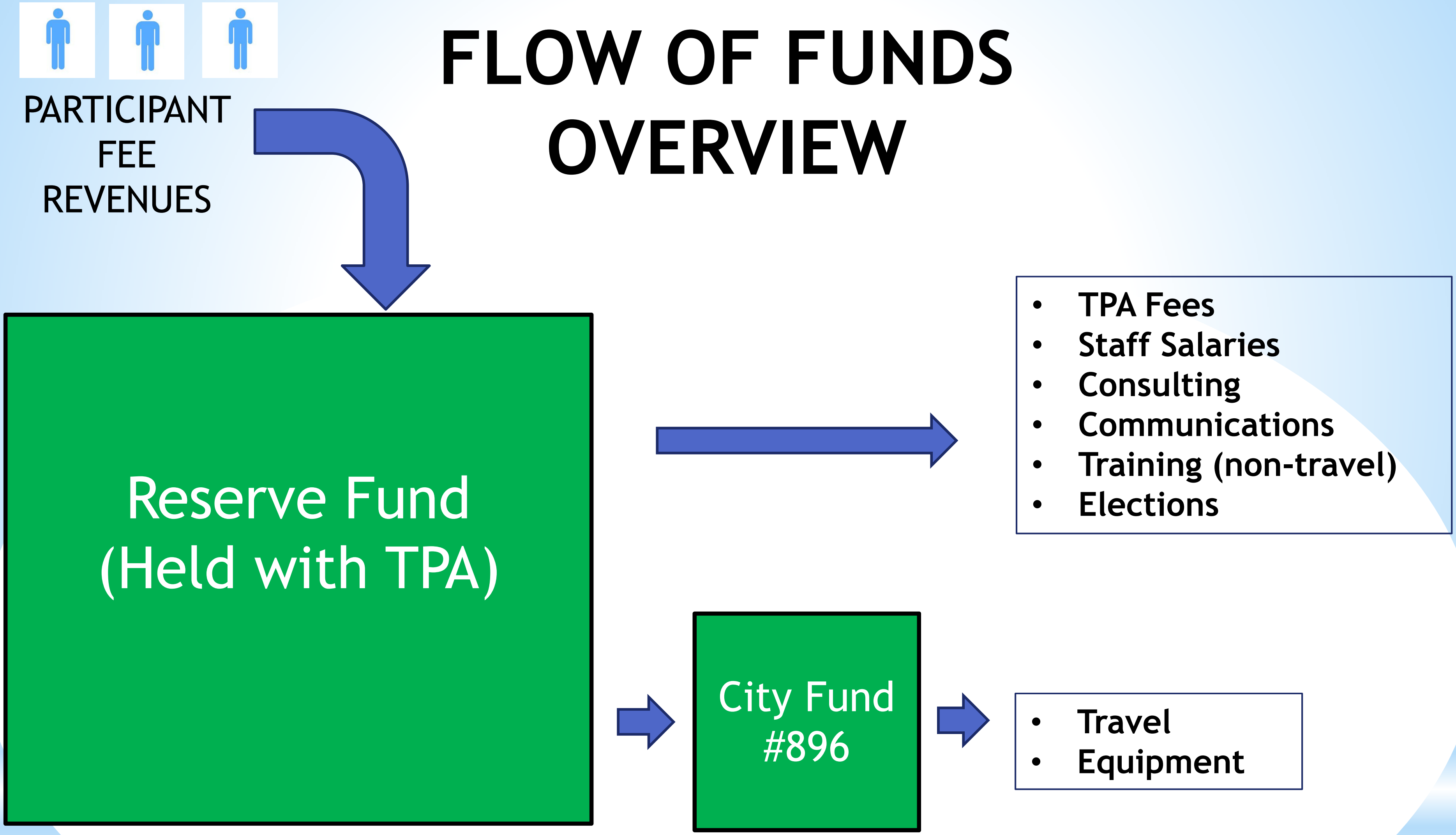
Approved by: ________________________________
Steven Montagna

CITY OF Los Angeles
DEFERRED COMPENSATION PLAN

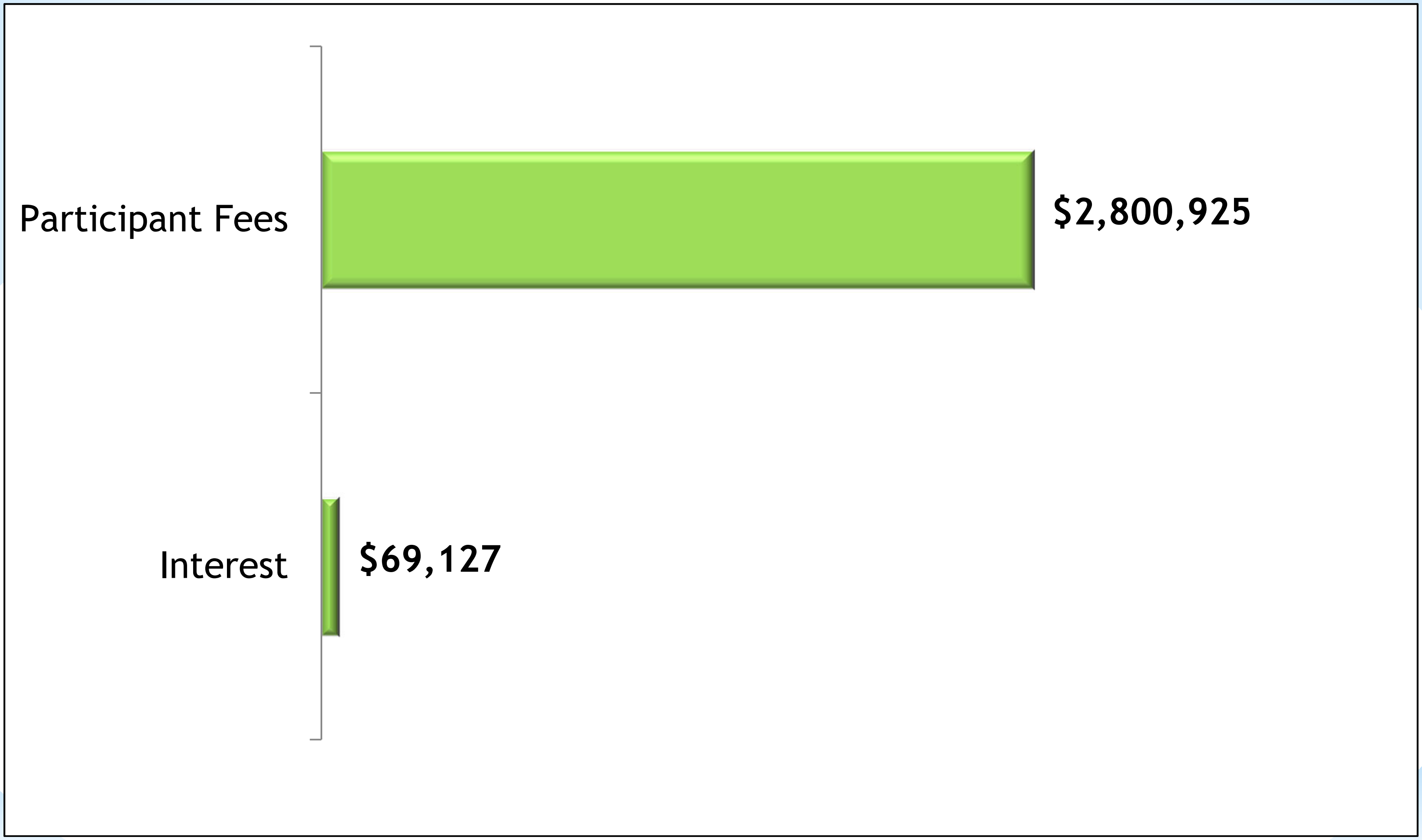
PLAN BUDGET & RESOURCES REVIEW

February 5, 2019

FLOW OF FUNDS OVERVIEW

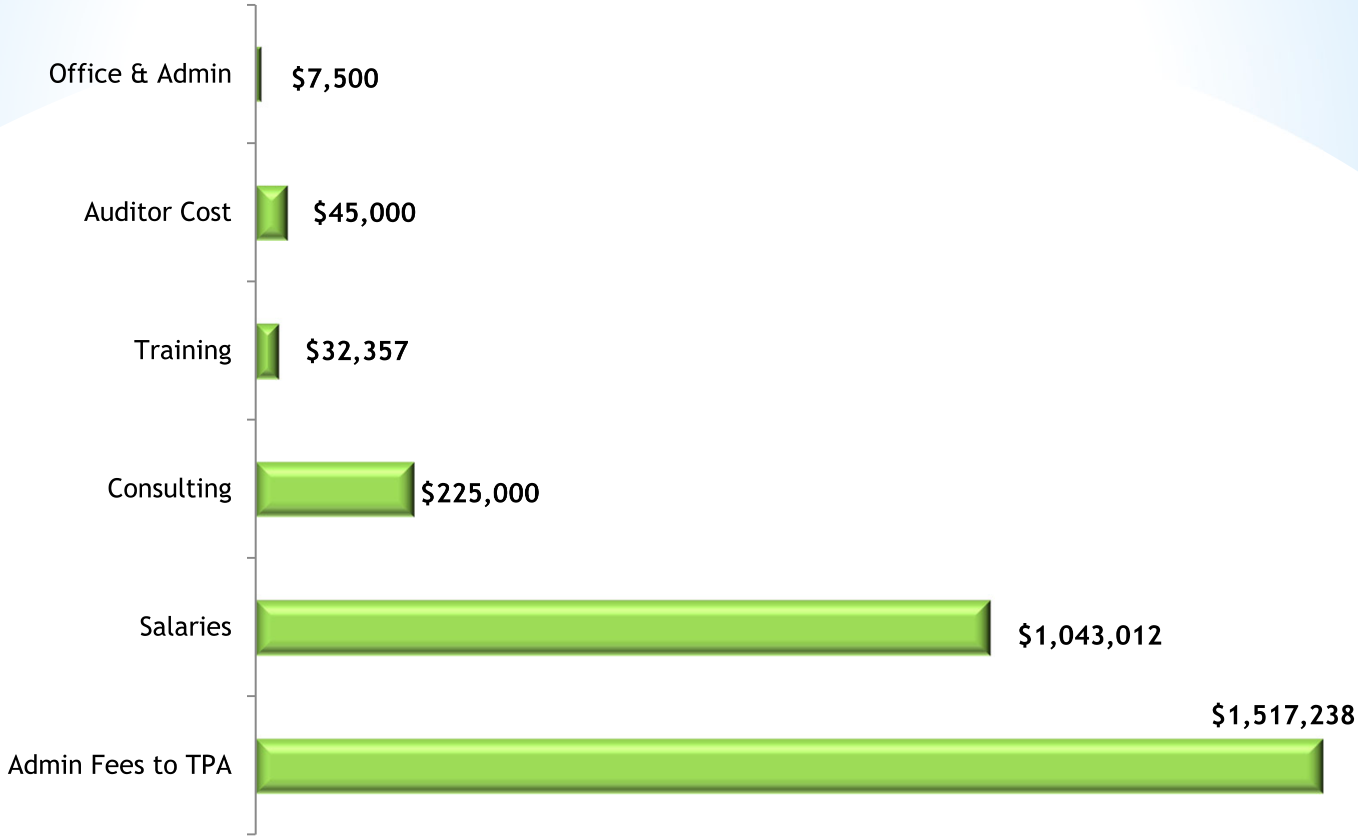


Projected 2019 REVENUES



Annual Total - **$2.87 million**

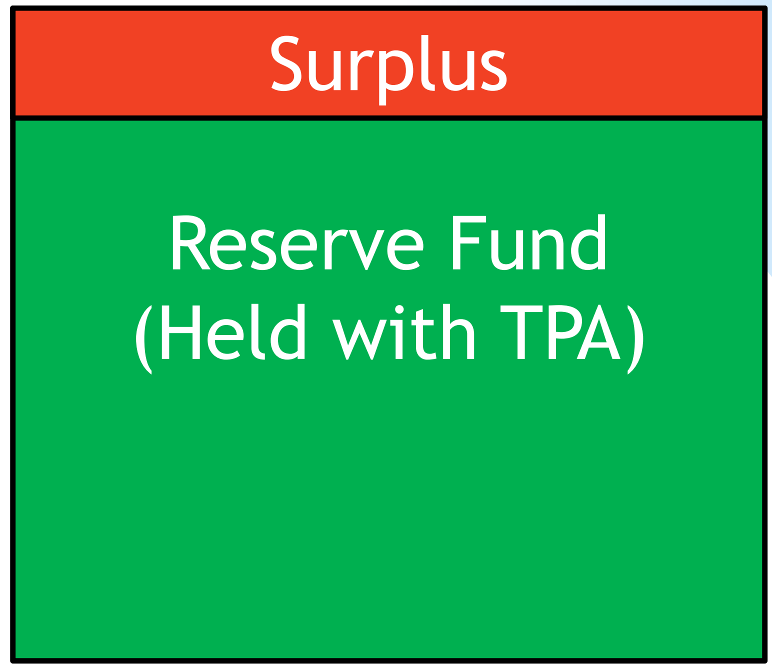
PROJECTED 2019 EXPENDITURES



Annual Total - **$2.87 million**

SURPLUS TARGET

- Adopted Reserve Fund surplus target is 50% of annual operating expenses (approximately $1.4 million in 2019)
- Historical surplus has been maintained above that target
- Board previously established a “structural deficit” in relationship of revenues to expenses to gradually reduce surplus
- As of 09/30/18, surplus was **$3.5 million**



RESERVE FUND KEY ASSUMPTIONS

Current

→

Expenses Inflation Adjustment Factor	*Enrollment Adjustment Factor*	*Asset Growth Adjustment Factor*	*Stable Value Funds Interest Assumption*	*Basis Points Charged Against Participant Accounts*	*Fee Cap*
2.0%	**2.0%**	**6.5%**	**2.0%**	**0.09%**	**$115**

Current

→

Personnel Avg. Special Rate	*City Attorney Avg. Special Rate*
100%	**100%**

These assumptions were last updated by the Board on March 20, 2018.

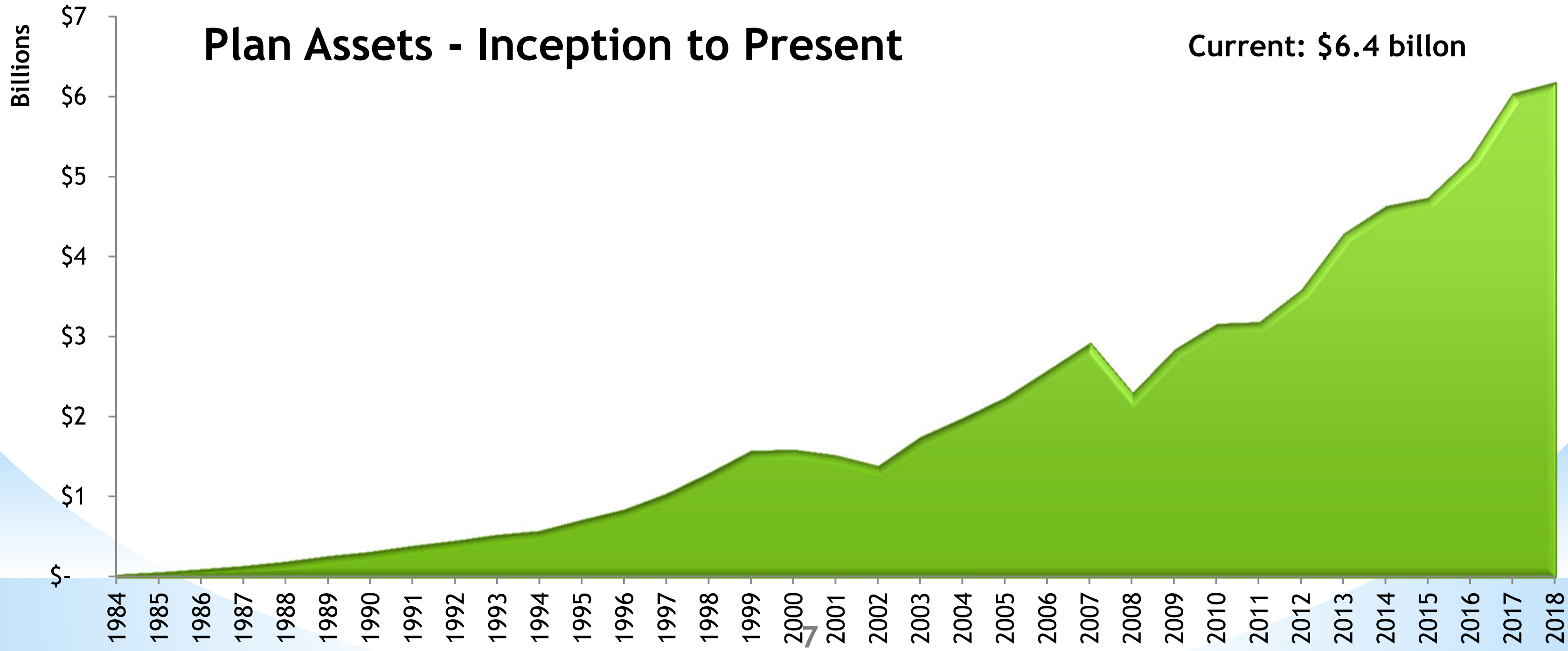
KEY ASSUMPTIONS

Plan Asset Growth

Current: **6.5%**

Where Applied: Growth rate for Plan assets

Considerations: Recent growth higher than current assumption, but bond/equity bull markets aging



KEY ASSUMPTIONS
Plan Asset Growth

Year	Assets	% Change
1984	$ 17,990,298	N/A
1985	$ 48,584,697	170%
1986	$ 84,762,277	43%
1987	$ 126,921,243	33%
1988	$ 180,395,336	30%
1989	$ 249,105,465	28%
1990	$ 303,691,355	18%
1991	$ 378,018,448	20%
1992	$ 441,306,161	14%
1993	$ 516,401,147	15%
1994	$ 564,392,235	9%
1995	$ 702,779,928	20%
1996	$ 831,689,383	15%
1997	$ 1,029,129,147	19%
1998	$ 1,285,271,264	20%
1999	$ 1,564,440,301	18%
2000	$ 1,578,565,882	1%
2001	$ 1,508,545,448	-5%
2002	$ 1,373,444,396	-10%
2003	$ 1,737,260,679	21%
2004	$ 1,973,665,625	12%
2005	$ 2,230,031,810	11%
2006	$ 2,566,734,158	13%
2007	$ 2,909,282,960	12%
2008	$ 2,279,918,897	-28%
2009	$ 2,828,435,629	19%
2010	$ 3,154,860,910	10%
2011	$ 3,174,274,111	1%
2012	$ 3,578,684,906	11%
2013	$ 4,277,754,120	16%
2014	$ 4,622,493,622	7%
2015	$ 4,726,682,745	2%
2016	$ 5,221,905,502	10%
2017	$ 6,027,047,083	15%
2018	$ 6,167,288,137	2%

2018 Plan Asset totals as of 12/31/2018

Potential Growth Rate Scenarios	
Last 15 years average-->	**7.8%**
Last 10 years average-->	**9.6%**
Last 5 years average-->	**7.6%**
Actuarial Potential Growth Rate -->	**6.7%**

Projected Growth Rate Including ROR		
Current Assets (as of 12/31/2018)	$	6,167,288,137
Net Annual Contributions	$	44,059,058
Projected ROR (per Mercer)*		5.82%
Earnings Growth	$	358,936,170
Projected Ending Balance	$	6,581,208,964
Projected Annual Growth Rate		**7.6%**

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

KEY ASSUMPTIONS
Net Participation

Current: 2%

Where Applied: Estimated growth in participant accounts

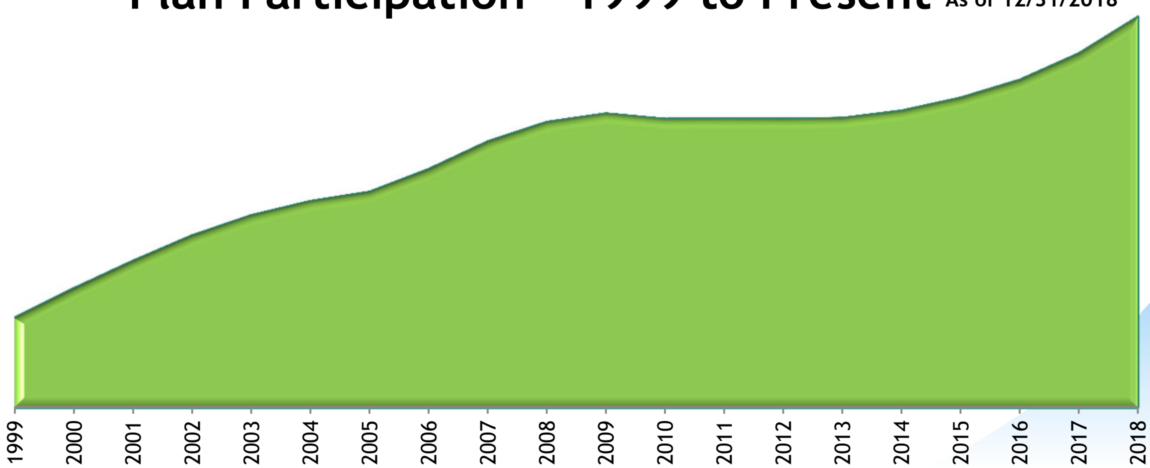
Considerations: Net growth is rising; 2018 increase highest since 2002

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%

Participant totals As of 12/31/2018

Plan Participation - 1999 to Present

Current: 47,508
As of 12/31/2018



KEY ASSUMPTIONS

Administrative Expense Inflation

Current: 2%

Where Applied: Salary costs, Training costs, and Office/Admin costs

Considerations:

- Cost of living increases may be below this rate over near and mid-term
- Positions often filled at lower level than position authority
- Training costs/admin costs generally lower than budgeted amount

KEY ASSUMPTIONS
Indirect Salary Costs

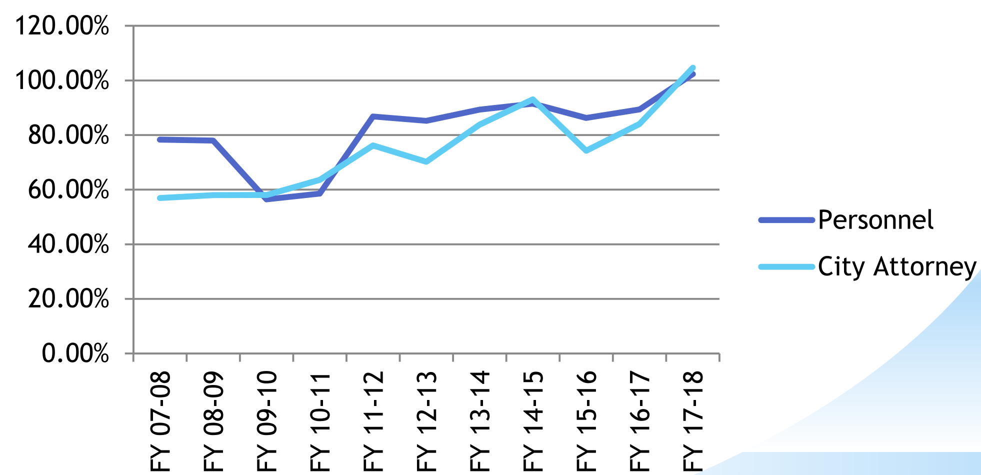
FY 17-18 #40 Special Rates (Final):
- Personnel – 102.34%
- City Attorney – 104.67%

5-Year Average:
- Personnel – **91.76%**
- City Attorney – **87.98%**

Current Assumptions:
- Personnel – **100%**
- City Attorney – **100%**

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

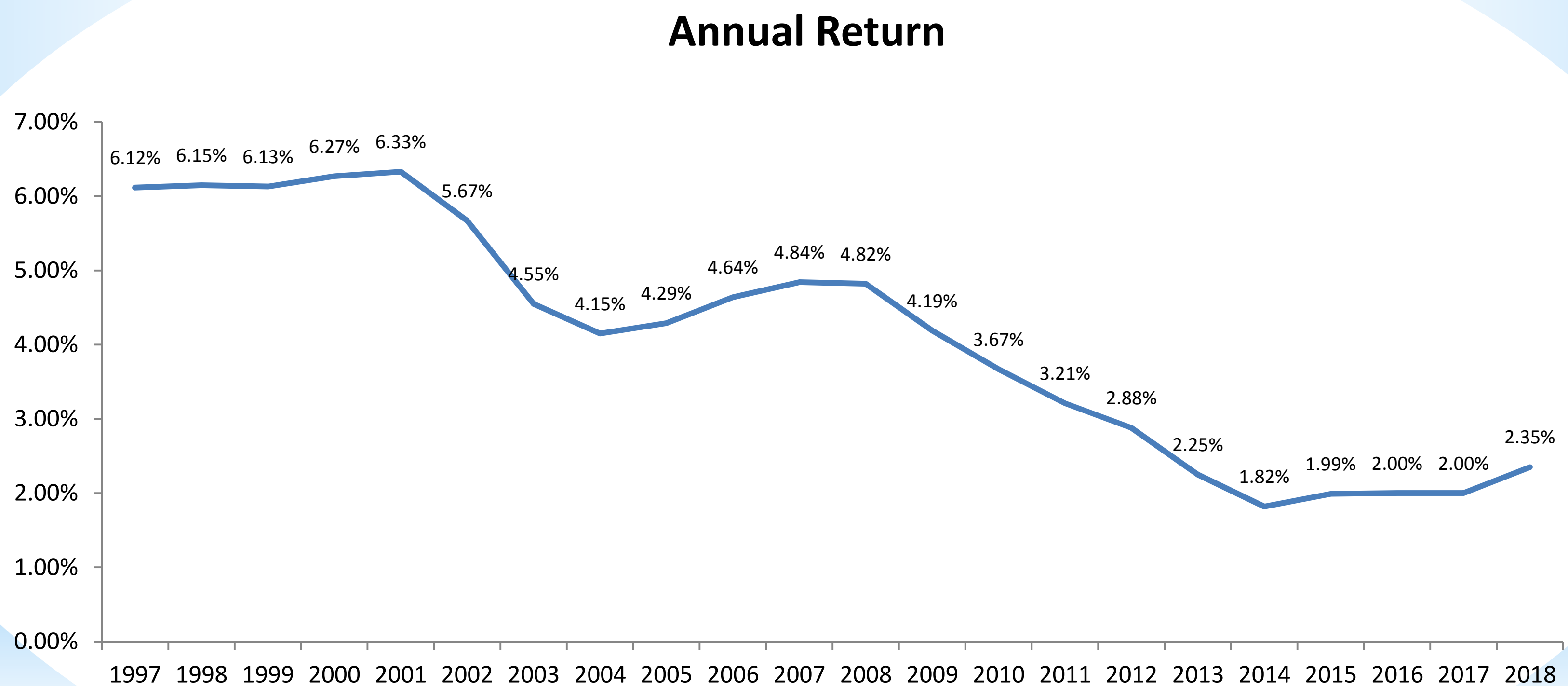
Fiscal Year	Personnel	City Attorney
FY 07-08	78.30%	56.91%
FY 08-09	77.94%	57.96%
FY 09-10	56.43%	58.03%
FY 10-11	58.56%	63.59%
FY 11-12	86.77%	76.17%
FY 12-13	85.23%	70.19%
FY 13-14	89.30%	83.83%
FY 14-15	91.51%	93.09%
FY 15-16	86.28%	74.25%
FY 16-17	89.37%	84.04%
FY 17-18	102.34%	104.67%
All Avg	**82.00%**	**74.79%**
5-Yr Avg	**91.76%**	**87.98%**



KEY ASSUMPTIONS

Stable Value Fund Interest

Current: **2%**



KEY ASSUMPTIONS
Participant Fees

Current:

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

Where Applied: Fees assessed against participant accounts, up to 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

Attachment B

DEFERRED COMPENSATION PLAN		
PROJECTED REVENUES/EXPENDITURES **Plan Year 2019**		
REVENUES		
Starting Balance on 01/01/19	$	3,468,414
Estimated Annual Administrative Fee Revenue	$	2,800,925
Estimated 2019 Interest Earnings (2.5%)	$	86,409
Opening Balance Plus Projected Revenues	**$**	**6,355,748**
EXPENDITURES		
Participant Administrative Fees Owed to TPA	$	(1,517,368)
Estimated Personnel Department Reimbursements	$	(736,439)
Estimated City Attorney Reimbursements	$	(181,334)
Estimated Investment Consulting Costs	$	(190,000)
Estimated Plan Administration Consulting Costs	$	(20,000)
Estimated Outside Tax Counsel Consulting Costs	$	(15,000)
Plan Audit	$	(45,000)
Communications	$	(50,000)
Travel/Training/Education	$	(33,004)
Elections Administration	$	-
Office and Administrative	$	(7,000)
Governmental Meetings	$	(500)
Total Estimated Expenditures	**$**	**(2,795,645)**
Annual Revenues Less Annual Expenditures	**$**	**91,689**
Projected Ending Balance on 12/31/19	**$**	**3,560,102**

Detail regarding budget items and assumptions included therein:

REVENUES

- ***Starting Balance on 01/01/19*** – 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.
- ***Estimated Annual 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%. Plan assets are impacted by both investment gains as well as participant contributions/rollovers.
- ***Estimated 2019 Interest*** – The assumed 2019 average rate of return for the Stable Value Fund is 2.0%.

EXPENDITURES

- ***Participant Administrative Fees Owed to Plan TPA*** – The City's contractual obligation to the Plan TPA is $32.00 per participant. The long-term projected participant growth rate is 3%.
- ***Estimated Personnel Department and City Attorney Reimbursements*** – The City's Plan funds certain percentages of direct and indirect staffing costs for its various positions. The estimated expenditures for these positions for 2019 take into account current paygrade levels and other factors. These rates reflect the most current Special Rate information for calculating indirect costs.
- ***Estimated Investment, Plan Administration, and Outside Tax Counsel Consulting Costs*** – The Board has contracts for various consulting services and also pays for tax consulting services on an as-needed basis via contracts administered by the City Attorney's Office. Staff projects a total of $225,000 in consulting expenditures for 2019.
- ***Plan Audit*** – A Plan audit approved by the Board will take place in 2019 at a cost of $45,000. After reviewing the audit results, the Board will then determine whether additional audits will occur and at what frequency.
- ***Communications*** – This category includes special communication costs over and above the amounts already included within the Plan Administrator budget.
- ***Travel/Training/Education*** – For Plan Year 2018, the Board adopted an annual training/travel amount of $32,357. Staff recommends that this amount remain unchanged in 2019.
- ***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.