CITY OF Los Angeles
DEFERRED COMPENSATION PLAN

Board Report 20-06

Date: February 18, 2020

To: Board of Deferred Compensation Administration

From: Staff and the Plan Governance and Administrative Issues Committee

Subject: 2020 Resources Review and Annual Budget Adoption Update

Recommendation:
That the Board of Deferred Compensation Administration (Board):

(a) Approve the following Deferred Compensation Plan (DCP) Growth and Expense variable and Fee variable assumptions for use in projecting future DCP Reserve Fund balances:
  (1) DCP Assets Growth Rate - 7%;
  (2) Net Enrollment Growth Rate - 3%;
  (3) Annual Expenses Increase Factor - 2%;
  (4) Special Rates Increase Factor: Personnel - 115%;
  (5) Special Rates Increase Factor: City Attorney - 115%;
  (6) Stable Value Interest Rate - 2%;
  (7) Participant Fees: Annual Basis Point Charge - 0.09%;
  (8) Participant Fees: Annual Dollar Cap - $115; and

(b) Approve for the quarter ending September 30, 2020, a reduction of the quarterly basis point fee assessment from 2.25 basis points to 1.125 basis points, and a reduction in the quarterly fee cap amount from $28.75 to $14.38.

Discussion:
At its meeting on March 20, 2018, the Board directed staff to convene the Plan Governance & Administrative Issues Committee (Committee) annually to conduct Deferred Compensation Plan (DCP) resource reviews. These reviews include analysis and recommendations related to: (a) assumptions for key variables approved by the Board for the purpose of projecting future DCP Reserve Fund balances; as well as (b) modifications, if any, related to DCP participant fees or expenses.

The current year's review with the Committee took place on November 26, 2019. 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 target reserve (**Attachment A**). Staff's and the Committee's analysis and recommendations 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: 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 (collectively, the Reserve Fund). 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 Reserve Fund balance was $4 million versus the target balance of $1.6 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. Two categories of variables are included: (a) Growth and Expense variables, and (b) Fee variables. Staff will separately address actions related to each set of variables.

(1) Growth and Expense Variables

The current adopted Growth and Expense variable assumptions are summarized in the table below:

Growth and Expense Variables	Current
DCP Assets Growth Rate	7%
Net Enrollment Growth Rate	3%
Annual Expenses Increase Factor	2%
Special Rates Increase Factor: Personnel	115%
Special Rates Increase Factor: City Attorney	115%
Stable Value Interest Rate	2%

Following review, the Committee and staff recommend maintaining current assumptions related to all DCP Growth and Expense variables based on the following:

- **Asset Growth** – Both the historical averages, as well as the assumed long-term overall DCP investment rate of return provided by Mercer Investments (Mercer), support a continued 7.0% assumed growth rate. As a result, staff and the Committee recommend adoption of an assumed 7.0% asset growth rate.

- **Net Enrollment Growth Rate** – Net enrollments have risen by an average annual rate of 3.5% over the last five years and average annual 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 full account liquidations following 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. Staff and the Committee recommend adoption of an assumed 3.0% net enrollment growth rate.
- **Annual Expense Increase Factor** – New ongoing expenses (including the costs of an annual DCP audit and outside tax counsel services) are included in base costs, meaning the primary driver of administrative expense growth will come from staffing costs (which are impacted by both salary increases as well as staff vacancies). Staff and the Committee recommend adoption of an assumed 2.0% annual expenses increase factor.
- **Special Rates Increase Factor** – 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 can be volatile and tend to trend higher rather than lower, staff and the Committee recommend adoption of an assumed 115% special rates increase factor for Personnel Department and City Attorney staffing.
- **Stable Value Fund Interest** – 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 and the Committee recommend adoption of an assumed 2.0% Stable Value Fund interest rate.

(2) Fee Variables

Participant fee variables are included within assumptions for projecting long-term Reserve Fund balances, but the fees themselves also may also be modified as a consequence of the Board's review. The current adopted Fee variables are summarized in the table below:

Fee Variables	Current
Participant Fees: Annual Basis Point Charge	0.09%
Participant Fees: Annual Dollar Cap	$115

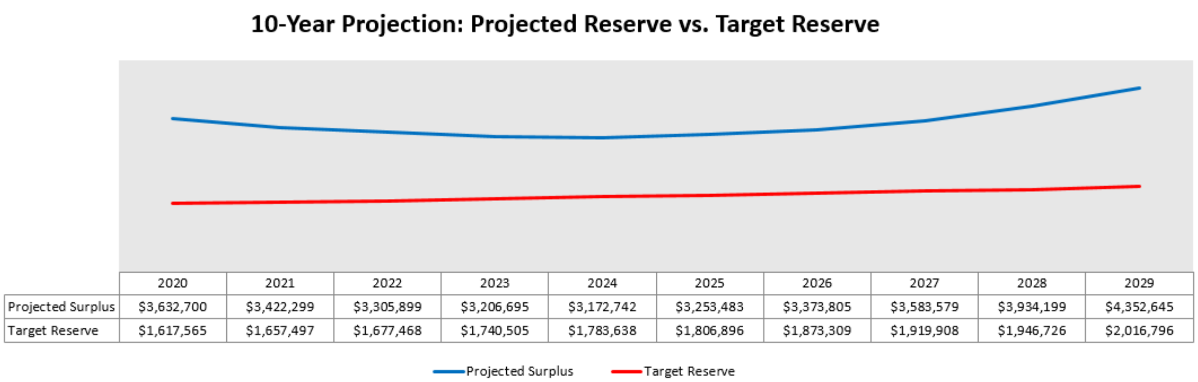
Revenue collected from participant fees fluctuates based on changes in the total value of DCP assets. In general, assets that grow faster than the assumed growth rate will generate higher actual revenues, while assets that grow less than the assumed growth rate will generate lower actual revenues. In setting participant fees, the Board considers the need to have sufficient revenues to fund DCP expenses while maintaining an amount that does not exceed a prudent Reserve Fund balance.

Potential modifications to participant fees must be considered in the context of various scenarios for DCP asset fluctuations. As part of the annual review, staff provided the Committee with, a range of revenue scenarios updating ten-year forecasts with DCP data as of September 30, 2019; current expense information; and assumptions for key variables as discussed elsewhere in this report. Since the Committee meeting, staffing cost calculations were updated to incorporate recent salary increases.

- **Reserve Fund 10-Year Projection: Baseline Scenario**

The Baseline Scenario incorporates current Growth and Expense variables and no change to Fee variables. The projected ten-year reserve in the Baseline Scenario of $4.5 million is above the ten-year target reserve of $2 million. The Reserve Fund balance under the Baseline Scenario is projected to gradually decrease through 2024 before increasing from 2025 through 2029.

Baseline Illustration



	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Projected Surplus	$3,632,700	$3,422,299	$3,305,899	$3,206,695	$3,172,742	$3,253,483	$3,373,805	$3,583,579	$3,934,199	$4,352,645
Target Reserve	$1,617,565	$1,657,497	$1,677,468	$1,740,505	$1,783,638	$1,806,896	$1,873,309	$1,919,908	$1,946,726	$2,016,796

- **Reserve Fund Ten-Year Projection: Market Downturn Scenario**

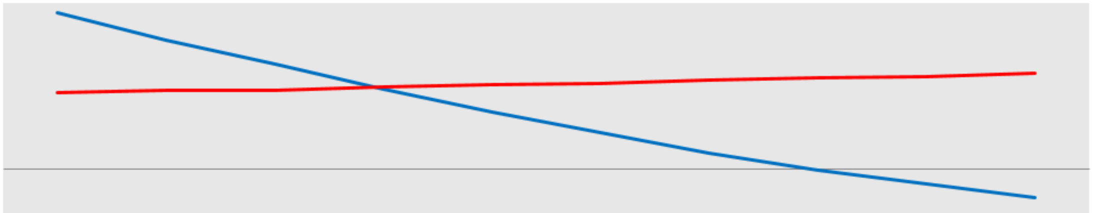
The Market Downturn Scenario incorporates most current Growth and Expense variables and no change in Fee variables, but illustrates the impact of a 30% one-year decline in assets due to an extreme downturn in equity markets. Since 2008, the DCP and its participants have benefited from a long-running 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 increasing contributions.

The DCP has experienced market-related annual asset declines, with the worst occurring in 2008, which resulted in a calendar year 22% decline. Looking at the S&P 500 as proxy for equity markets, the peak to trough decline was even larger (between its peak on October 9, 2007, and trough of March 9, 2009, the S&P 500 declined by 57%).

The Reserve Fund balance under the Market Downturn Scenario would fall sharply from 2020 to 2029 and would result in a negative balance by 2028.

Market Downturn Illustration

10-Year Projection: Projected Reserve vs. Target Reserve



	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Projected Surplus	$3,301,914	$2,730,956	$2,222,012	$1,695,902	$1,198,140	$775,444	$349,784	$(32,092)	$(322,138)	$(596,956)
Target Reserve	$1,617,565	$1,657,497	$1,677,468	$1,740,505	$1,783,638	$1,806,896	$1,873,309	$1,919,908	$1,946,726	$2,016,796

Projected Surplus   Target Reserve

- **Reserve Fund Ten-Year Projection: Participant Fee Reduction Scenarios**

Given the projected surplus over and above the target reserve, staff and the Committee considered the following broad-based fee reduction scenarios:

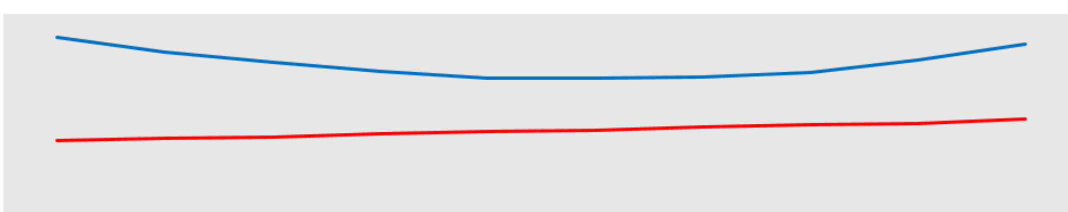
A. **Basis Point Reduction Scenario** - Reducing the current 0.9% asset-based fee presently assessed on all participant account balances to 0.085% up to the $115 fee cap.
B. **Fee Cap Reduction Scenario** – Maintaining the current .09% asset-based fee but reducing the $115 fee cap to $110 (impacting the approximately 14,800 participants - 2% of total - who presently have balances above the fee cap threshold).
C. **Combined Scenario** - A combined scenario where both the administrative fee and fee cap are reduced by the amounts included in the prior two scenarios.
D. **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%.

(i) <u>Basis Point Reduction Scenario</u>

Reducing participant fees by one-half basis point (0.005%), from .09% to .085%, results in the projected Reserve Fund balance decreasing gradually through 2025 and increasing steadily after.

Basis Point Reduction Illustration (8.5 basis points)

10-Year Projection: Projected Reserve vs. Target Reserve



	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Projected Surplus	$3,571,444	$3,294,273	$3,105,179	$2,926,918	$2,807,075	$2,794,587	$2,813,801	$2,914,010	$3,145,989	$3,436,052
Target Reserve	$1,617,565	$1,657,497	$1,677,468	$1,740,505	$1,783,638	$1,806,896	$1,873,309	$1,919,908	$1,946,726	$2,016,796

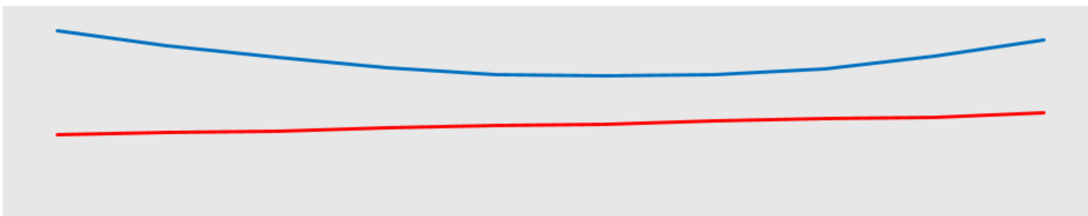
Projected Surplus   Target Reserve

(ii) Fee Cap Reduction Scenario

Reducing the fee cap from $115 to $100 results in the projected Reserve Fund balance decreasing through 2025 and increasing steadily afterward, largely consistent with the Basis Point Reduction Scenario.

Fee Cap Reduction Illustration ($110 Fee Cap)

10-Year Projection: Projected Reserve vs. Target Reserve



	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Projected Surplus	$3,554,518	$3,262,026	$3,059,477	$2,869,912	$2,741,229	$2,722,705	$2,739,058	$2,839,983	$3,076,693	$3,375,979
Target Reserve	$1,617,565	$1,657,497	$1,677,468	$1,740,505	$1,783,638	$1,806,896	$1,873,309	$1,919,908	$1,946,726	$2,016,796

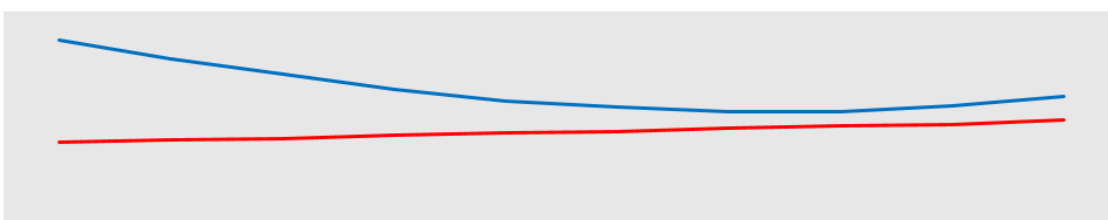
Projected Surplus — Target Reserve

(iii) Combined Scenario

Reducing the asset-based fee to 0.085% and the fee cap to $110 results in the projected Reserve Fund balance steadily decreasing through 2027 before gradually rebounding.

Combined Illustration

10-Year Projection: Projected Reserve vs. Target Reserve



	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Projected Surplus	$3,493,261	$3,133,999	$2,858,757	$2,590,136	$2,375,562	$2,263,809	$2,179,054	$2,170,414	$2,288,482	$2,459,386
Target Reserve	$1,617,565	$1,657,497	$1,677,468	$1,740,505	$1,783,638	$1,806,896	$1,873,309	$1,919,908	$1,946,726	$2,016,796

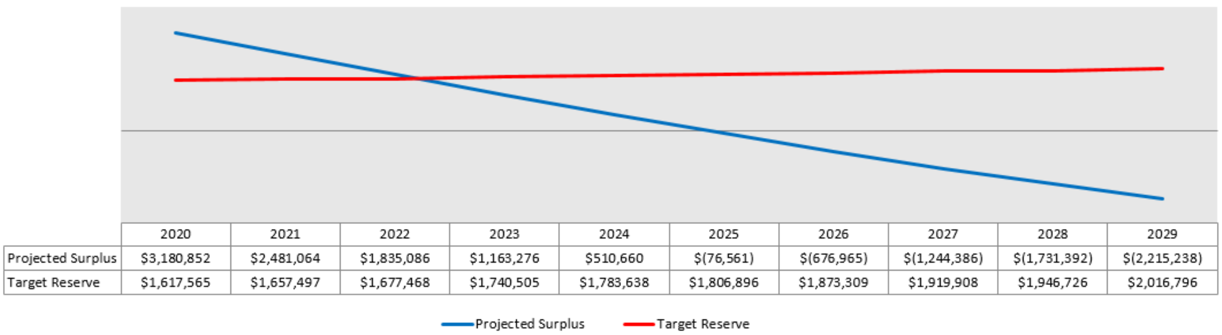
Projected Surplus — Target Reserve

(iv) Combined Fee Reductions and Market Downturn Scenario

Reducing the asset-based fee to 0.085% and the fee cap to $110 during a market downturn resulting in a 30% reduction in participant assets would cause the Reserve Fund balance to fall below target in 2022 and fall below zero in 2025.

Combined Fee Reductions and Market Downturn Illustration

10-Year Projection: Projected Reserve vs. Target Reserve



	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Projected Surplus	$3,180,852	$2,481,064	$1,835,086	$1,163,276	$510,660	$(76,561)	$(676,965)	$(1,244,386)	$(1,731,392)	$(2,215,238)
Target Reserve	$1,617,565	$1,657,497	$1,677,468	$1,740,505	$1,783,638	$1,806,896	$1,873,309	$1,919,908	$1,946,726	$2,016,796

B. Participant Fees Recommendations

The Committee and staff do not recommend structural reductions to asset-based fees or the fee cap based on this year's review. A significant or extended decline in the investment markets - a real risk over the next ten years - could result in a challenging Reserve Fund deficit. The Committee and staff find that maintaining the current fee structure is appropriate based on current data and circumstances.

However, as part of this year's review, the Committee and staff considered the merits and feasibility of an approach sometimes used in other agencies whereby the DCP would provide participants with a "fee holiday" suspending or reducing fees for a limited time period (e.g., one quarter). A one-time quarterly fee reduction would help to bring the projected Reserve Fund balance in better alignment with the targeted reserve without the risks related to a structural fee reduction. Fee holidays, to the extent they could be repeated, would also help promote the value and success of the DCP to participants and non-participants. Voya has indicated it can administer a fee holiday.

The DCP's administrative fee is assessed on a quarterly basis. A fee holiday representing 50% of quarterly fees would result in a reduction in the DCP reserve of approximately $360,000 and reduction of the DCP's Reserve Fund balance by approximately 19%. To administer a 50% fee holiday for one quarter, the fee would change to 1.125 basis points with a cap of $14.38, broken out as follows:

	Basis Point Fee	Fee Cap	Projected 2020 Q3 Revenue
Normal Fee Assessment	2.25 Basis Points (0.0225%)	$28.75	$802,987
50% Fee Reduction Assessment	1.125 Basis Points (0.01125%)	$14.38	$440,464
		Reduction in Quarterly Revenue	**($362,523)**

The following table provides illustrations of how the proposed fee holiday would impact participants at certain account balances:

Participant Balance	Fee Assessed in Normal Quarter	Fee Assessed in 50% Reduction Quarter
$5,000	$1.13	$0.56
$25,000	$5.63	$2.81
$50,000	$11.25	$5.63
$100,000	$22.50	$11.25
$150,000	$28.75	$14.38

After considering administrative requirements and communications opportunities, staff recommends that the fee reduction be implemented in the third quarter of 2020 to coincide with the DCP's annual National Retirement Security Week (NRSW) campaign. NRSW presents an opportune time as participants are already engaging with the DCP in connection with the annual campaign. If the fee reduction holiday is approved, staff will communicate this via the quarterly DCP newsletter, citywide email, and the DCP website.

Staff recommends that the Board approve for the quarter ending September 30, 2020, a reduction of the quarterly basis point fee assessment from 2.25 basis points to 1.125 basis points, and a reduction in the quarterly fee cap amount from $28.75 to $14.38.

C. 2020 DP Budget Adoption Update

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. Pending the Board's actions relative to its consideration of the budget-related items in this report, staff will submit a proposed 2020 budget for approval at the Board's March 17, 2020, meeting.

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

February 18, 2020

Flow of Funds Overview

Revenue from Participant Fees

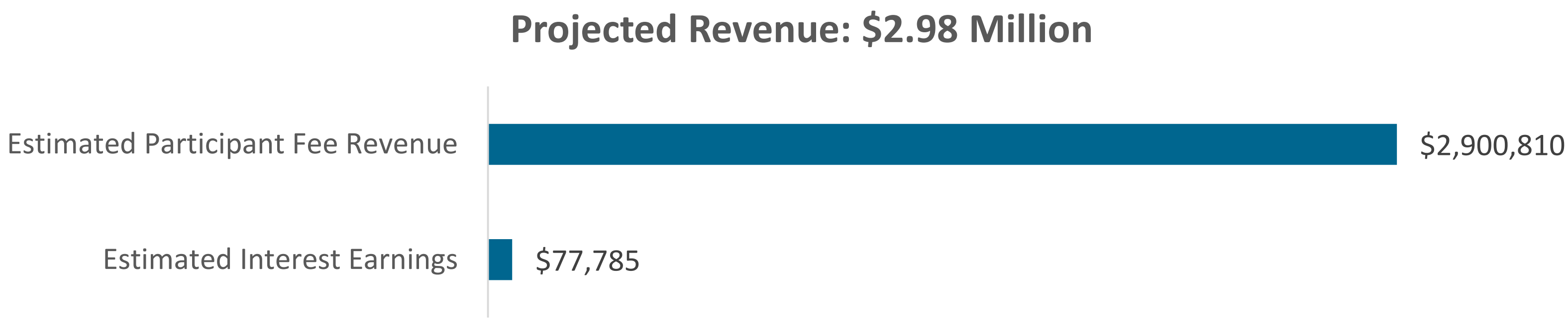
Reserve Fund (Held with TPA)

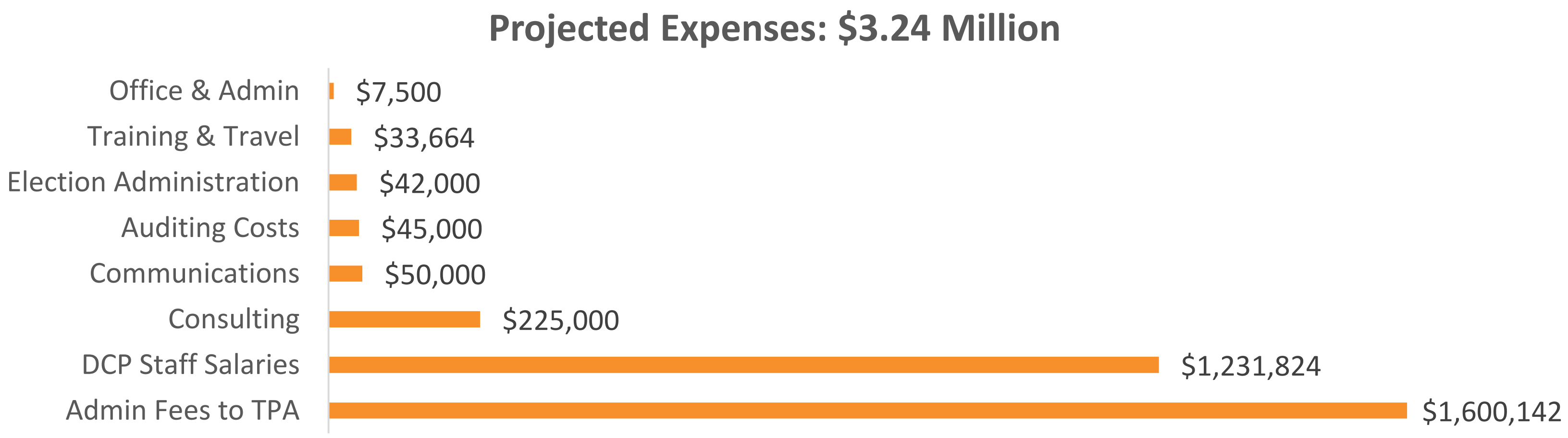
Expenses
TPA Fees
Staff Salaries
Consulting
Audits
Communications
Training (non-travel)
Elections

City Fund #896

Expenses
Travel
Equipment

Projected 2020 Revenue & Expenditures

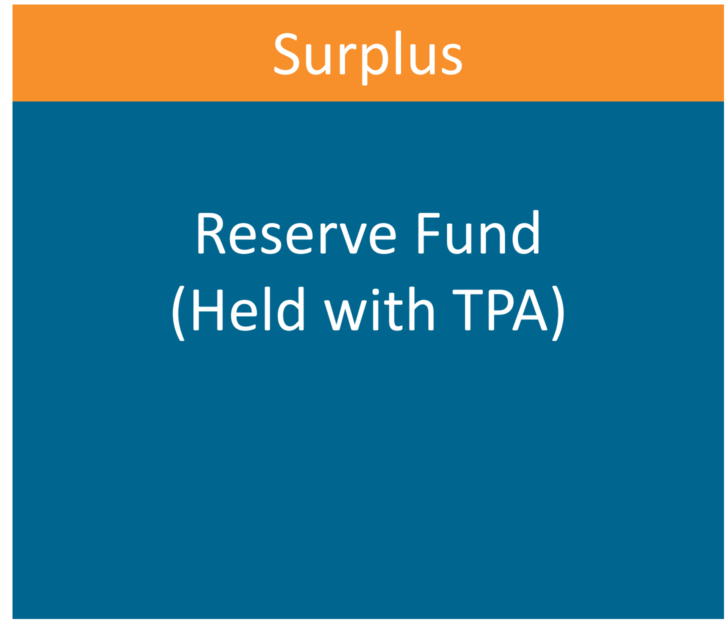




Expenses are expected to exceed revenue by $256,535, a deficit of 8%.

Reserve Fund Target

- The adopted Reserve Fund target is 50% of the DCP's annual operating expenses (equating to a target Reserve Fund balance of $1.6 million in 2020).
- Historically, the Reserve Fund has been maintained above that target.
- The Board previously established a "structural deficit" to gradually reduce the surplus.
- As of September 30, 2019, the Reserve Fund balance was approximately **$3.9 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%

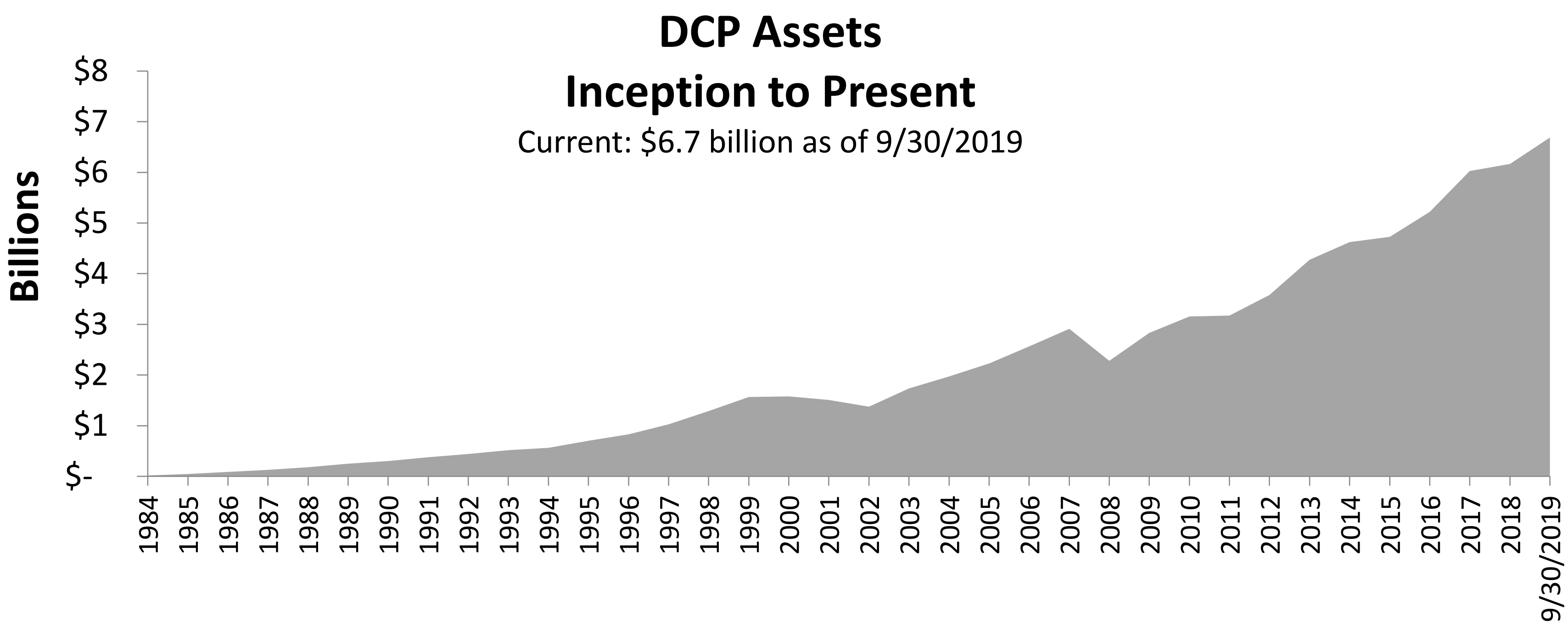
These assumptions were last reviewed and approved by the Board on February 19, 2019.

Key Assumption: DCP Asset Growth

Current: 7.0%

<u>Where Applied</u>: Growth rate for DCP assets

<u>Considerations</u>: Recent growth has been higher than the 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

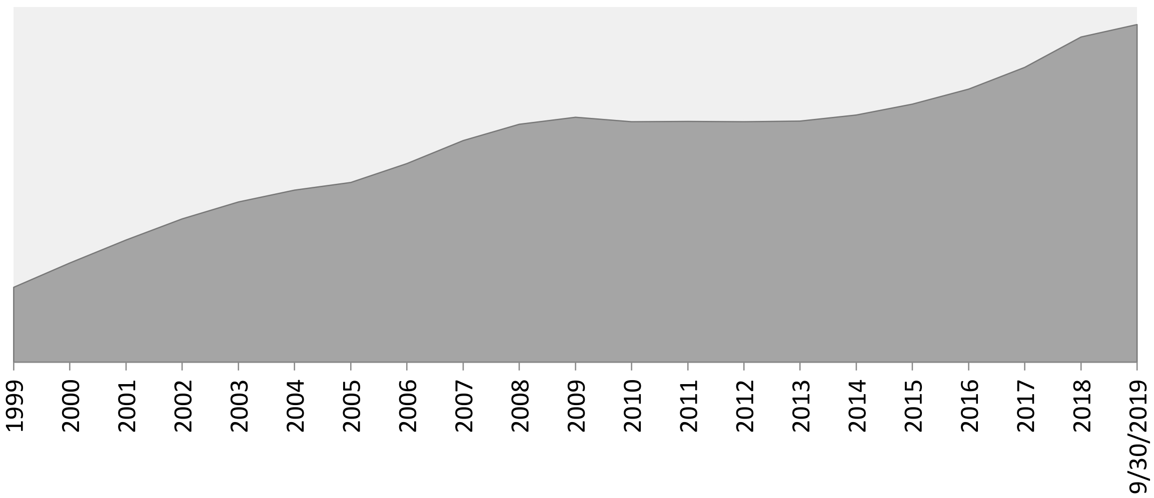
<u>Considerations</u>: Net growth rose sharply in 2018 but has leveled out somewhat in 2019. The average net enrollment rate over the last five years is 3.5% and over the last ten years is 1.8%.

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% annually for the period 2019-2021.
- Training and admin costs have generally been lower than the budgeted amount historically, but training utilization has increased in recent years.

Key Assumption: Indirect Salary Costs

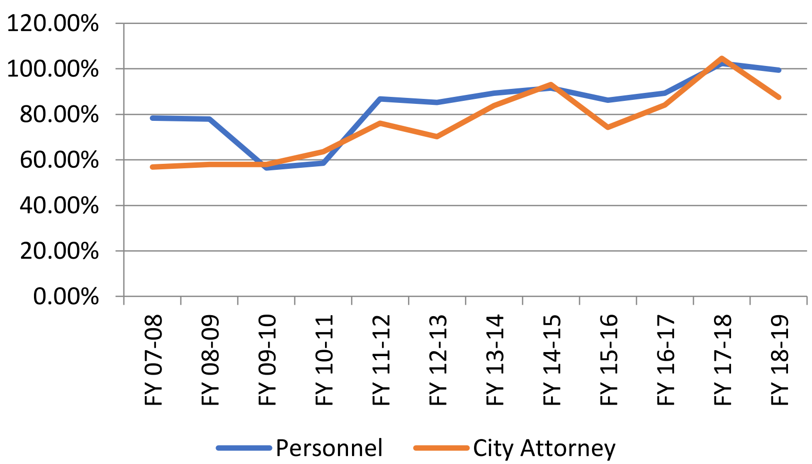
Current Assumptions:
Personnel Department – 115%
City Attorney – 115%

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

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

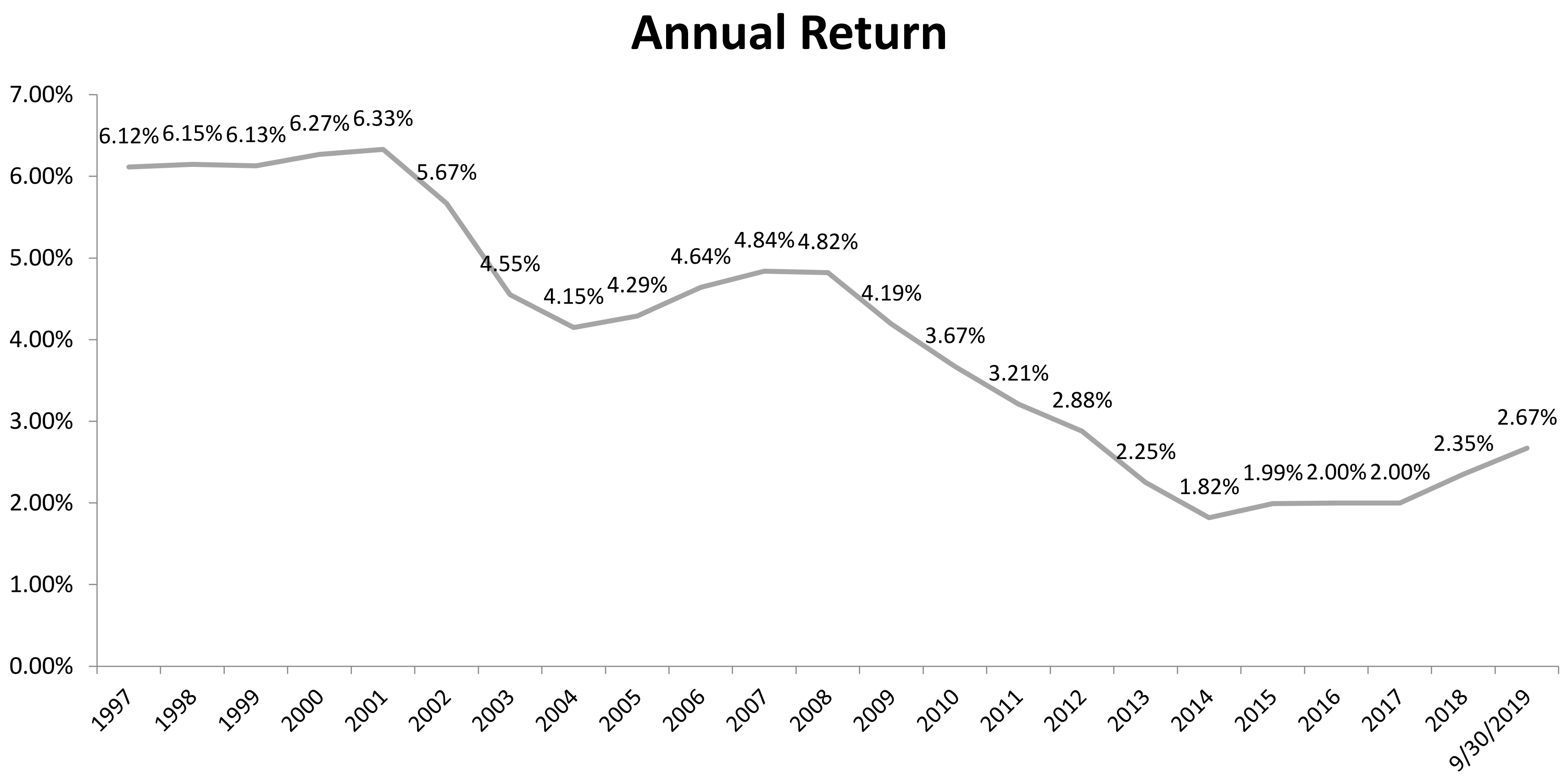
FY 18-19 #41 Special Rates (Final):
- Personnel – **99.39%**
- City Attorney – **87.45%**

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.