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DEFERRED COMPENSATION PLAN BOARD REPORT 06-23



Date: June 1, 2006

To: Board of Deferred Compensation Administration

From: Staff

Subject: Deferred Compensation Plan Budget Status Report - Quarter Ending 03/31/06

Recommendation:

That the Board of Deferred Compensation Administration (a) receive and file the following status report on Deferred Compensation Plan budget accounts for the quarter ending 03/31/06; and (b) approve reimbursement from the Deferred Compensation Plan Trust Fund #896 to the Personnel Department for \$48,159.32 for the quarter ending 03/31/06; (c) approve an increase in the "Office & Administrative Expense" budget from \$2,000 to \$10,000; and (d) consider staff proposed scenarios regarding potential Plan fee reductions.

Discussion:

Staff has completed its budgetary review and reconciliation of administrative fees/expenses for the quarter ending 03/31/06. This review consolidates reporting for the Payroll Fee Trust Fund and Administrative Fee Reserve Fund as part of the Plan's overall operating budget.

Reimbursements - Staff is recommending reimbursement to the Personnel Department from the Payroll Fee Trust Fund #896 in the amount of \$48,159.32. The Personnel Department is reimbursed for:

- Salaries for the 2.5 positions presently servicing the Plan;
- Retirement on salaries using a percentage (19.94%) derived from the Fringe Benefits CAP rate for retirement costs only for the 05/06 fiscal year
- Office supplies for staff using a standard Personnel Department formula (\$1,000 per full-time person annually);
- Overhead of 3.4% of the expenses listed above that line (see footnote)¹.

¹ This is the last known City overhead rate, since this percentage is no longer computed. As discussed at a Board meeting in October 1997, the General City Overhead rate and Retirement rate were previously supplied on Schedule G of the CAO's Fees for Special Services instructions. Schedule G was one of two methods used in cost accounting for special service programs; the other method involved what are called Cost Allocation Plan ("CAP") rates. Beginning with the 96/97 fiscal year, the Schedule G method was eliminated and all programs were directed to use the CAP rates. Because the Council had previously (in 1993) specified that the Plan would only be billed for direct costs (i.e. retirement and General City overhead), staff recommended, and the Board approved, billing the program for the last known General City Overhead rate and each fiscal year's Retirement rate (which can be derived from the Fringe Benefits CAPS rate) until such time as this matter is revisited by Council.

Rolling Four-Quarter Projected Income/Expenses - Following is an updated rolling four-quarter forecast of revenue/expenses for the Deferred Compensation Plan budget accounts. The projected surplus in the Fund over a one-year period has risen from the prior quarter's projected surplus of \$2,126,166 to the current \$2,235,514, a 5.1% increase.

The following table provides a breakdown of estimated revenues/expenses over the next 4-quarter cycle:

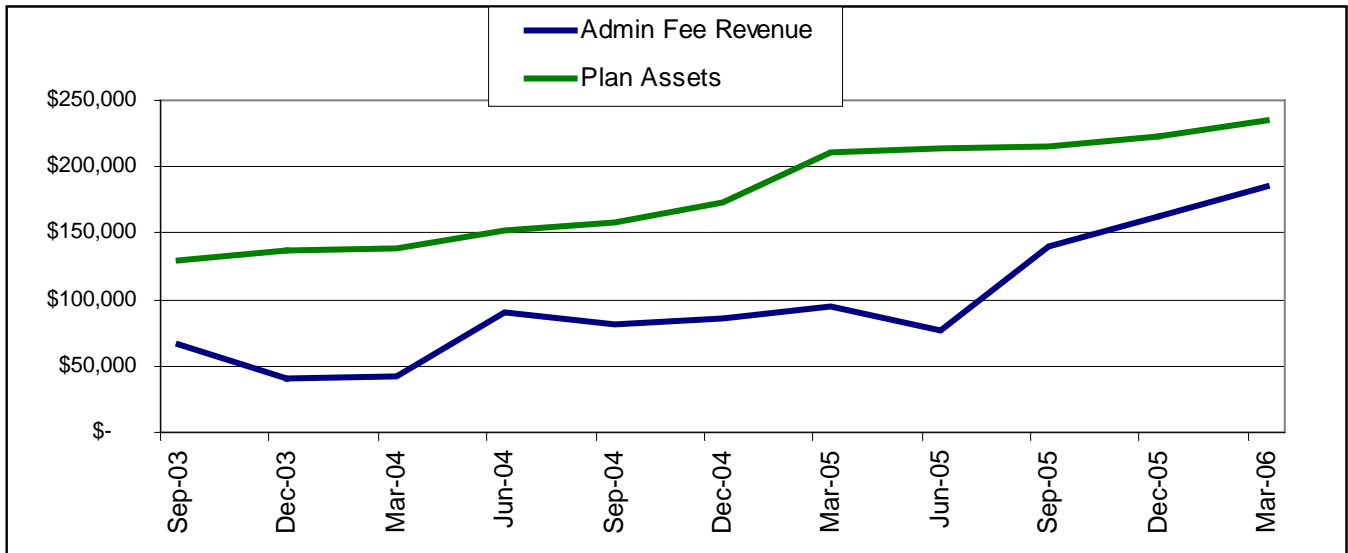
| PROJECTED REVENUE/EXPENSES: 4/1/06-3/31/07 | | |
|---|----|------------------|
| REVENUE | | |
| Projected Fifty-Cent Fees to Payroll Fee Trust Fund | \$ | 344,760 |
| Projected Deposits to Administrative Fee Reserve Fund | \$ | 562,883 |
| Interest | \$ | 18,000 |
| Total | \$ | 925,643 |
| ANNUAL EXPENSES | | |
| Personnel Reimbursements | \$ | (236,281) |
| NAGDCA Dues/Conference Expenses | \$ | (25,000) |
| Consulting Fees | \$ | (300,000) |
| Office & Admin | \$ | (10,000) |
| Quarterly Fee - Asset Allocation Funds | \$ | (18,000) |
| Total | \$ | (589,281) |
| Annual Revenue Less Annual Expenses | \$ | 336,362 |
| CURRENT SURPLUS | | |
| Current Surplus | \$ | 1,899,153 |
| Projected Total Surplus:3/31/07 | \$ | 2,235,514 |

As Board members may recall from prior staff communications regarding the Plan's budget accounts for calendar year 2006, staff deliberately employed very conservative assumptions in its estimates. The adopted budget contained increased staffing and consulting expenses, and staff wished to be cautious in ensuring the Plan did not take on new obligations it could not afford on an ongoing basis. Following is an update with respect to various revenue/expense items and the staff assumptions used in developing them.

Revenues: Payroll ("50-Cent") Fee - Enrollment growth has started off strong in 2006, with total participation having risen 1.8% through the first four months of the year, compared to 1.9% for all of 2005. This suggests that revenues from the fifty-cent fee will continue their consistent pattern of year-over-year growth. Last year's total payroll fee revenue was \$338,071. Staff is projecting, conservatively, 2% growth in this figure for 2006.

Administrative Fee – Administrative fee revenue is driven by Plan assets, not participation. Because of the greater volatility of Plan assets, actual receipts are less predictable than payroll fee revenue. As a result, in projecting forward, staff uses the prior four quarter's total revenue as its estimate for the next four quarters, without including an inflation factor, to protect against the possibility of meaningful market declines.

The following graph provides an illustration of the relationship between Plan assets and administrative fee revenue (Plan assets have been proportionately reduced for illustration purposes). The graph demonstrates how administrative fee revenue began to move up sharply once Plan assets topped \$2 billion.



Expenses: Staffing – Projected reimbursements to the Personnel Department for the next four-quarter period assume hiring an additional one and one-half positions in approximately July 2006. Actual salary costs will vary depending on whether these positions are hired into or remain in lieu of their position authority, vs. being hired/promoted to their full position authority. As part of this report, staff is also requesting authority from the Board to increase the budgeted amount for “Office & Administrative Expense” from \$2,000 to \$10,000 to cover the cost of computer equipment purchases for the two additional staff, as well as additional advertising costs for Requests for Proposal expected to be issued within the next four quarter period.

Consulting – The adopted budget also includes an increase in consulting costs to \$300,000 annually. Although it is unlikely that in 2006 consulting expenses will reach that level, staff has retained this estimate in its current projections.

Reserve Status – The Board adopted a target reserve of \$1 million. Given staff’s projections of a \$2.2 million surplus by the end of calendar year 2006, the surplus presently provides a substantial margin relative to the target.

Ongoing Revenue vs. Ongoing Expenses – Based on current projections, the amount by which ongoing revenue is expected to exceed ongoing expenses is approximately \$336,000. Given the conservative assumptions utilized by staff in generating these projections, the actual surplus over the next year and beyond may well be substantially higher absent a significant decline in the markets. Administrative fee revenues were \$184,518 in the quarter ending 3/31/06, a 13.6% increase over the prior quarter and an amount that, if annualized, could add another \$175,000 to the annual surplus – bringing the total operating surplus to over \$500,000.

Given the growth in surplus amounts, staff believes that the Plan has reached a point where the Board may wish to contemplate fee reductions. The following discussion will identify potential sources of fee reductions and the impact on the Plan's operating budget.

Potential Candidates for Fee Reductions – There are two sources of revenue for the Plan wherein a fee reduction might be applied: the Payroll (“50-Cent”) Fee, and the Administrative Fee. Staff recommends that any fee reduction contemplated by the Board be abundantly conservative in its underlying assumptions, to guard against the kind of market declines that occurred in 2000-2002 (where Plan assets were at one point less than 60% of current asset totals).

Staff recommends that the Board consider two potential strategies for fee reduction:

- (1) A reduction, but not elimination, of the Payroll Fee (e.g. reducing it from 50 cents to 25 cents, which would eliminate approximately \$175,000 of revenue);
- (2) Placing an administrative fee cap on large participant accounts such that participants having reached certain thresholds would no longer have unlimited administrative fee liability.

To provide further background related to option (2), at present a participant with a \$5,000 account balance pays an administrative fee of \$5.50, while a participant with a \$500,000 account balance pays \$550.00, despite the fact that the services received by both individuals are essentially the same. In the past, with Plan revenue and expenses much more tightly aligned, any contemplated fee reduction for holders of large account balances would have needed to have been offset by a corresponding fee increase for holders of smaller account balances. However, operating surpluses now make it feasible to consider capping large-account fees without having to raise fees elsewhere.

The table below provides an illustration of the revenue loss that would apply in various fee-capping scenarios. For example, capping fees at the \$500,000 account balance level would result in an annual revenue loss of \$12,139, while capping at the \$400,000 account level would result in an estimated loss of \$31,103.

| Account Size | # of Participants | Account Values | Current Revenue Collected | Current Revenue Owed to Record-keeper | Revenue w/\$500k Fee Cap (\$550 max admin fee per year) | Revenue w/\$400k Fee Cap (\$440 max admin fee per year) | Revenue w/\$300k Fee Cap (\$330 max admin fee per year) | Revenue w/\$200k Fee Cap (\$220 max admin fee per year) | |
|------------------------------------|-------------------|------------------|---------------------------|---------------------------------------|---|---|---|---|---------------------|
| Less than \$50k | 21,054 | \$ 362,460,507 | \$ 398,707 | \$ 1,021,330 | \$ 398,707 | \$ 398,707 | \$ 398,707 | \$ 398,707 | |
| \$50k-\$100k | 6,775 | \$ 491,173,732 | \$ 540,291 | \$ 328,655 | \$ 540,291 | \$ 540,291 | \$ 540,291 | \$ 540,291 | |
| \$100k-\$200k | 5,084 | \$ 703,998,988 | \$ 774,399 | \$ 246,625 | \$ 774,399 | \$ 774,399 | \$ 774,399 | \$ 774,399 | |
| \$200k-\$300k | 1,468 | \$ 352,925,230 | \$ 388,218 | \$ 71,213 | \$ 388,218 | \$ 388,218 | \$ 388,218 | \$ 322,960 | |
| \$300k-\$400k | 524 | \$ 178,135,930 | \$ 195,950 | \$ 25,419 | \$ 195,950 | \$ 195,950 | \$ 172,920 | \$ 115,280 | |
| \$400k-\$500k | 177 | \$ 77,940,585 | \$ 85,735 | \$ 8,586 | \$ 85,735 | \$ 77,880 | \$ 58,410 | \$ 38,940 | |
| Over \$500k | 101 | \$ 61,535,189 | \$ 67,689 | \$ 4,900 | \$ 55,550 | \$ 44,440 | \$ 33,330 | \$ 22,220 | |
| | 35,183 | \$ 2,228,170,161 | \$ 2,450,987 | \$ 1,706,727 | \$ 2,438,848 | \$ 2,419,884 | \$ 2,366,274 | \$ 2,212,797 | |
| Annual Revenue Loss----> | | | | | | \$ (12,139) | \$ (31,103) | \$ (84,713) | \$ (238,191) |

One possible combined action the Board could take would involve reducing the payroll fee from 50 to 25 cents, and capping the administrative fee at the \$400,000 account balance level. This would result in a loss of revenue of approximately \$206,103, or approximately 60% of the projected operating surplus for the next four quarter period.

Conclusion – The Board could move forward immediately on one of the described fee reduction models, request that staff explore additional potential scenarios, or wait to further monitor the revenue/expense trend over coming quarters. In any event, staff’s finding is that the Plan’s balance sheet is strong, employing prudently conservative assumptions, and is well positioned to meet the Plan’s ongoing resource needs.

Submitted by: _____
Steven Montagna

Approved by: _____
Maryanne Keehn

| DEFERRED COMPENSATION PLAN QUARTERLY BUDGET REVIEW | |
|--|---------------------|
| ADMINISTRATIVE AND OPERATING EXPENSES | |
| QUARTER ENDING 3/31/06 | |
| STARTING BALANCE | |
| Payroll Fee Trust Fund Ending Balance - 12/31/05 | \$ 437,261 |
| Administrative Fee Reserve Fund Balance - 12/31/05 | \$ 1,407,404 |
| Total | \$ 1,844,664 |
| REVENUES/FEES | |
| City Payroll Administrative ("Fifty Cent") Fees | \$ 66,080 |
| DWP Payroll Administrative ("Fifty Cent") Fees | \$ 16,483 |
| Interest Earnings on Payroll Fee Trust Fund | \$ 3,629 |
| Administrative Fee Reserve Fund Deposits | \$ 184,518 |
| Interest Earnings on Administrative Fee Reserve Fund | \$ 16,589 |
| Total Revenue/Fees | \$ 287,300 |
| STARTING BALANCE + REVENUE/FEES | \$ 2,131,964 |
| EXPENDITURES | |
| Personnel Department Reimbursements | \$ (48,838) |
| Consulting Costs | \$ (83,956) |
| NAGDCA | \$ (600) |
| Office & Admin | \$ - |
| Quarterly Fee - Asset Allocation Funds | \$ (4,500) |
| TOTAL EXPENDITURES | \$ (137,894) |
| Actual Payroll Fee Trust Fund Ending Balance (3/31/06) | \$ 390,059 |
| Actual Administrative Fee Reserve Fund Ending Balance (3/31/06) | \$ 1,604,011 |
| ACTUAL TOTAL BALANCE AS OF 3/31/06 | \$ 1,994,070 |
| ENCUMBRANCES/LIABILITIES | |
| Reimbursements: (Personnel: 3 Mos. Ending 12/31/05) | \$ (46,758) |
| Reimbursements: (Personnel: 3 Mos. Ending 3/31/06) | \$ (48,159) |
| TOTAL LIABILITIES | \$ (94,917) |
| ASSETS LESS EXPENDITURES/LIABILITIES | \$ 1,899,153 |
| Personnel Reimbursement Summary - 3 Months Ending 3/31/06 | |
| Personnel - Salaries | \$ 38,239.11 |
| Personnel - FY 05-06 Retirement @ 19.84% | \$ 7,586.64 |
| Personnel - Office Supplies | \$ 750.00 |
| Personnel - Overhead | \$ 1,583.58 |
| Personnel Reimbursements | \$ 48,159.32 |

| PAYROLL FEE TRUST FUND ACTIVITY REPORT | | | |
|---|------------|----|-------------|
| Quarterly Summary - 3/31/06 | | | |
| JANUARY '06 | | | |
| Opening Balance | 01/01/06 | \$ | 437,260.53 |
| CR-CITY ADMIN FEES | 01/05/06 | \$ | 10,897.50 |
| CR-DWP ADMIN FEES | 01/04/06 | \$ | 2,345.00 |
| CR-DWP ADMIN FEES | 01/18/06 | \$ | 2,348.00 |
| CR-CITY ADMIN FEES | 01/18/06 | \$ | 11,002.00 |
| CR-DWP ADMIN FEES | 01/31/06 | \$ | 2,351.50 |
| CONSULTING-MERCER | 01/25/06 | \$ | (2,868.75) |
| CONSULTING-MERCER | 01/06/06 | \$ | (9,157.50) |
| CONSULTING-MERCER | 01/18/06 | \$ | (1,445.00) |
| JV-INTEREST | 01/19/06 | \$ | 677.96 |
| | Subtotal-> | \$ | 453,411.24 |
| FEBRUARY '06 | | | |
| CR-DWP ADMIN FEES | 02/14/06 | \$ | 2,359.50 |
| CR-CITY ADMIN FEES | 02/02/06 | \$ | 10,978.00 |
| CR-DWP ADMIN FEES | 02/28/06 | \$ | 2,360.50 |
| CR-CITY ADMIN FEES | 02/16/06 | \$ | 11,041.00 |
| NAGDCA (annual membership fee) | 02/15/06 | \$ | (600.00) |
| PERSONNEL REIMBURSEMENTS | 02/09/06 | \$ | (48,837.98) |
| CONSULTING-MERCER | 02/09/06 | \$ | (9,091.25) |
| JV-INTEREST | 02/09/06 | \$ | 1,304.27 |
| | Subtotal-> | \$ | 422,925.28 |
| MARCH '06 | | | |
| CR-CITY ADMIN FEES | 03/02/06 | \$ | 11,056.50 |
| CR-DWP ADMIN FEES | 03/15/06 | \$ | 2,359.50 |
| CR-CITY ADMIN FEES | 03/16/06 | \$ | 11,105.00 |
| CR-DWP ADMIN FEES | 03/28/06 | \$ | 2,359.00 |
| CONSULTING-MERCER | 03/21/06 | \$ | (61,393.48) |
| JV-INTEREST | | \$ | 1,647.11 |
| | Subtotal-> | \$ | 390,058.91 |
| QUARTERLY SUMMARY | | | |
| OPENING BALANCE | | \$ | 437,260.53 |
| TOTAL CITY ADMIN FEES | | \$ | 66,080.00 |
| TOTAL DWP ADMIN FEES | | \$ | 16,483.00 |
| TOTAL INTEREST | | \$ | 3,629.34 |
| PERSONNEL REIMBURSEMENTS | | \$ | (48,837.98) |
| CONSULTING-MERCER | | \$ | (83,955.98) |
| NAGDCA | | \$ | (600.00) |
| OFFICE & ADMIN | | \$ | - |
| ENDING BALANCE | | \$ | 390,058.91 |